STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion	))	
vs.	)	Docket No. 01-0707
The Peoples Gas Light and Coke Company	)	
Reconciliation of revenues collected under gas adjustment charges with actual costs prudently included.	)))	

JOINT INITIAL BRIEF

OF

THE CITY OF CHICAGO

THE CITIZENS UTILITY BOARD

AND

THE PEOPLE OF THE STATE OF ILLINOIS

PUBLIC VERSION
Confidential information removed

June 30, 2005

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Pursuant to Section 200.80 of the Rules of Practice[1] of the Illinois Commerce Commission ("Commission" or "ICC") and the briefing schedule set by the Administrative Law Judge ("ALJ") in her ruling dated May 20, 2005, the CITY OF CHICAGO ("City") by its attorney, Mara S. Georges, Corporation Counsel, the CITIZENS UTILITY BOARD ("CUB"), and The PEOPLE OF THE STATE OF ILLINOIS, by and through Lisa Madigan, Illinois Attorney General ("AG"), (collectively "Governmental and Consumer Intervenors" or "GCI") submit their Joint Initial Brief in this proceeding. This proceeding is the reconciliation of Peoples Gas Light and Coke Company's ("Peoples Gas" or "PGL") recoverable purchased gas adjustment ("PGA") clause costs and collections for fiscal year 2001 ("FY 2001"). This brief addresses the factual and legal issues raised by the evidence of record and by the application of

[1] 83 Ill. Adm. Code Part 200.

the controlling provisions of the Public Utilities Act ("Act" or "PUA")[2] and relevant Illinois case law to the circumstances of this case.

I. SUMMARY/STATEMENT OF FACTS[3]

A. The Case: A Section 9-220 Reconciliation

The record in this Section 9-220 reconciliation proceeding presents evidence of a series of uncommon utility decisions, actions, and arrangements. The unusual factors presented in this record include:

- Peoples Gas' active participation in a strategic corporate initiative to increase the revenues of unregulated affiliates, at the expense of its ratepayers;

- Novel arrangements with unregulated affiliates of Enron Corporation ("Enron") and PGL's parent corporation, Peoples Energy Corporation ("Peoples Energy" or "PEC"), for the misuse of Peoples Gas' PGA assets and costs;

- Consensus positions among all non-utility parties on the fundamental issues of this reconciliation proceeding; and

- An unavoidable need to consider explicitly the credibility of the evidence presented by the utility.

B. Consensus On Fundamental Conclusions

The evidence of record supports a rare consensus of positions among the stakeholder parties in this proceeding. In major Commission cases, the record often reflects three distinct perspectives: that of the utility; that of the Commission Staff; and that of intervening consumers

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[2] 220 ILCS 5/1-101 *et seq.*

[3] To facilitate the Commission's review, this section is intended to serve as the statement of facts requested by the ALJ (*see*, ALJ Notice, May 5, 2005) and the summary of position required by Section 200.80 of the Commission's Rules of Practice. 83 Ill. Admin. Code §200.80.

and consumer representatives. In this case, on the threshold issue of the prudence of the utility's claimed costs, Staff and GCI agree. Peoples Gas recovered unreasonable and imprudently incurred costs through its FY 2001 Gas Charges.

- Both Staff and GCI agree that the Gas Purchase and Agency Agreement and significant portions of the costs it produced were imprudent.

- Both Staff and GCI agree that the profits generated by enovate came from its improper use of PGA assets and costs, activities performed with Peoples Gas' concurrence or active involvement.

- Both Staff and GCI agree that Peoples Gas' management and use of its Manlove storage field and contract storage was imprudent.

This consensus among parties is especially compelling because it reflects not only different perspectives, but distinctive analyses that nonetheless produced consistent conclusions. The Staff and GCI experts used very different approaches in their analyses of the documentary materials, quantitative data, technical information, and other facts in this case. Moreover, those parties whose experts conducted comprehensive examinations of the Peoples Gas-Enron interactions agree that the harm to ratepayers approached or exceeded $100 million.

C. The Enron-Related Deals

1. The Enron Strategy

In the late 1990's, Peoples Gas and Enron developed a proposal for a fixed rate bundled gas service, and Peoples Gas presented it to the Commission for approval. City-CUB Ex. 1.0 at 60, L. 1725-28. The Commission accepted the concept of a fixed rate service, but it modified certain particulars of Peoples Gas' filing because the proposed rate levels were excessive. *Id*. at 61, L. 1751-52. Peoples Gas, however, rejected the Commission's changes and declined to

implement the revised plan. *Id*. at 61, L. 1752-54. In the wake of that episode, Peoples Gas's parent firm, Peoples Energy, and Enron developed an alternative plan for increasing the parent's earnings. The strategy hinged on increasing Peoples Energy's unregulated "midstream" revenues by diverting revenues and economic opportunities from Peoples Gas (the regulated company) to Peoples Energy and its unregulated subsidiaries through a "Strategic Partnership" with Enron Corporation. *Id*. at 61-62, L. 1765-68. (For purposes of this brief, this strategic initiative is referred to as the "Enron Strategy").

After reviewing numerous internal documents from the involved entities, experts for Staff and GCI concluded that it was this corporate effort to exceed the profit levels available from regulated services that was the impetus for Peoples Gas' unusual activity in FY 2001. *Id*.; Staff Ex. 7.00 at 6, L. 117-19. The Enron Strategy required a base of assets the unregulated affiliates did not have. But, Peoples Energy exercised effective control over the regulated assets of Peoples Gas. These assets – including gas, contract storage, and operations of the Manlove Field storage facility – were used to support the midstream activities of unregulated Peoples Energy and Enron affiliates, to the detriment of utility ratepayers. City-CUB Ex. 1.0 at 42, L. 1195-1202.

The use of a utility's PGA assets is permissible, but only if certain conditions are met. The Commission's rules require that any revenues generated through transactions supported by costs recoverable through Peoples Gas' Gas Charge be used to offset the PGA charges customers pay. 83 Ill. Admin. Code §525.40(d) In violation of these rules, the benefits of transactions supported by Peoples Gas' PGA assets and costs instead were split among Enron and utility

affiliates, overriding Peoples Gas' obligation to manage its PGA costs prudently on behalf of its captive customers.

The Enron Strategy was implemented through a series of novel contracts and arrangements between Peoples Gas and various Enron or Peoples Energy affiliates. Among the affiliates was enovate, a joint venture of Enron and Peoples Energy. To prevent self-dealing, the PUA prohibits utilities from conducting business with affiliates without receiving prior Commission approval. 220 ILCS 5/7-101. Because enovate was an affiliate of Peoples Gas, Enron Midwest LLC ("Enron Midwest" or "EMW") was repeatedly used as an intermediary to hide unapproved transactions between Peoples Gas and its unregulated affiliates. Staff Ex. 9.00 at 6-7, L. 146-50; City-CUB Ex. 1.0 at 68, L. 1942-49. EMW became a conduit for transferring possible offsets to Peoples Gas' PGA charges from the utility to unregulated affiliates as midstream revenues.

The consequences for ratepayers of the strategic Peoples Energy-Enron transactions were negative and substantial. The harm resulted principally from two novel arrangements – the GPAA supply contract with Enron and (2) enovate, the Peoples Energy-Enron joint venture.

2. The GPAA

The Gas Purchase and Agency Agreement ("GPAA") between Peoples Gas and Enron North America Corporation ("ENA") was signed on September 16, 1999 and had a term of five years – October 1, 1999 through October 31, 2004. Staff Ex. 2.00, Attach. 1 at 1, 9. During the reconciliation period, the GPAA provided the utility with approximately 66% of its gas supply requirements, by far the single largest cost item for the utility. *Id*. at 6, L. 112-13. Yet, for this

single largest contract for its single largest cost item, Peoples Gas repeatedly claimed that it had conducted no economic analysis to determine whether the contract was economically advantageous for the utility and its ratepayers. PGL Ex. F at 14, L. 303-04; Apr. 20 Tr. At 1009-10. Commission Staff correctly concluded that Peoples Gas' claim that it did not conduct an economic analysis of a proposed contract of this magnitude is itself compelling evidence of imprudent management. Staff Ex. 2.00 at 12, L. 258-60; Staff Ex. 6.00 at 6, L. 102-09.

However, after discovery was re-opened in February 2004, the parties found through their searches of millions of pages of materials produced by Peoples Gas, that an economic analysis had, in fact, been performed. It was conducted by Mr. Roy Rodriguez, a manager in Peoples Energy's Risk Management group. City-CUB Ex. 1.0 at 17, L. 509-12. His analysis showed that the GPAA was a loser for Peoples Gas and would cost its ratepayers millions more than the procurement strategies Peoples Gas abandoned to sign the GPAA. *Id*. at 18, L. 523-24.

Shortly before the hearings commenced, the City's continuing search of discovery materials uncovered yet another pre-signing analysis of the GPAA. This second analysis directly contradicts the sworn testimony of David Wear, Peoples Gas' principal witness in the reconciliation proceeding. Mr. Wear testified that he had not conducted any economic analysis of the GPAA's provisions and that he had not conducted any analysis that compared the expected costs under the GPAA to expected costs under Peoples Gas' previous procurement strategies. Apr. 20, 2005 Tr. at 1009-1010. After denying that he had conducted any such analysis, Mr. Wear was presented with a spreadsheet taken from the compact disc provided in discovery that bore his name and contained electronic documents taken from his computer. *Id.* at 1010. According to the properties associated with the file, the spreadsheet was created on September 8,

1999 and last modified on September 10, 1999 – mere days before the GPAA was signed. *Id.* at 1011-12. The spreadsheet compared what Peoples Gas actually paid for gas over the previous four years and what it would have paid had the GPAA been in effect. *Id.* at 1012-13; Wear Cross Ex.15. The spreadsheet, marked as Wear Cross Ex. 15, showed that Peoples Gas would have paid over $50 million more under the GPAA than it actually had paid during the previous four years. Wear Cross Ex. 15. Despite his assertion that he had no recollection of Wear Cross Ex. 15, Mr. Wear readily and accurately recognized the analysis as a "backcast," undoubtedly because the document is, as the ALJ observed, "remarkably similar to the table that Mr. Wear had prepared as Exhibit No. 8 to ... Respondent's Exhibit C." Apr. 20, 2005 Tr. at 1055. Thus the utility's claim that it conducted no economic analysis was proved false.

With the credibility of the utility's principal witness so severely compromised respecting core issues in of this proceeding, the entire case presented by the utility is suspect. Such circumstances destroy any presumption that the utility's records and documentary evidence represent a complete and accurate account of its dealings.

Despite the utility's attempts to denigrate Mr. Rodriguez's analysis and Mr. Wear's professed inability to recall creation of the "backcast" analysis, the fact remains that at the time Peoples Gas decided to enter the GPAA, every economic analysis of the GPAA available to Peoples Gas showed it to be an unfavorable deal for the utility and its captive ratepayers. Even the assessment of these documents most favorable to the utility would support, at best, further analysis before signing the five-year deal. There is no reasonable basis for Peoples Gas' outright rejection of the analyses' consistent, cautionary results. Instead, Peoples Gas denied the

existence of the analyses, until its witnesses were confronted with them in sworn depositions or testimony.

Independent of Mr. Rodriguez's and Mr. Wear's analyses, expert witnesses for Staff and for City-CUB found that the terms of the GPAA alone are sufficient to demonstrate that the GPAA was a bad deal. City-CUB Ex. 1.0 at 10-15; Staff Ex. 3.00 at 10-15. Under various provisions of the GPAA, Peoples Gas ceded to Enron control over how much gas it would buy, when it would buy gas, and the price it would pay, with respect to significant segments of the gas supply it contracted to purchase from Enron. City-CUB Ex. 1.0 at 5, L. 104-08. Predictably, Enron took advantage of these provisions to increase its profits – at the expense of Peoples Gas and its ratepayers. *Id*. at 26-27, L. 757-77. Incredibly, Peoples Gas defended its imprudent acceptance of one such term – the Summer Incremental Quantity provision – by observing that Enron was able to increase its earnings at ratepayer expense only 94% of the time. PGL Ex. L at 10-11, L. 209-19.

3. enovate

Peoples Energy and Enron formed the joint venture known as enovate in April 2000, with an initial capital investment of only $100,000 each. City-CUB Ex. 1.0 at 65, L. 1863-65. enovate had more than $100 million in revenues and made more than $20 million in profits during the reconciliation period. *Id*. at 65, L. 1865-70. Experts for Staff and the City and CUB reviewed the available documentation and considered Peoples Gas' theory on the source of enovate's enormous profits. Those experts concluded that the only plausible explanation for enovate's more than 10,000% profit on its meager investment was its use of Peoples Gas' PGA

assets and costs. City-CUB Ex. 1.0 at 66, L. 1885-89; Staff Ex. 13.00 at 7-8, 132-66. enovate was at the center of the Enron Strategy and a vital link in deals designed to increase revenues flowing to unregulated utility and Enron affiliates.

Peoples Gas has not offered any plausible alternative explanation for enovate's questionable deals or for its extraordinary profits. Mr. Morrow, an enovate board member, testified that enovate earned its massive profits through speculative trading and physical gas transactions in the upper Midwest. PGL Ex. N at 4, L. 61-66. But, Mr. Morrow and enovate's parent firm – Peoples Energy Resources Corporation ("PERC") – could neither quantify enovate's trading gains nor identify deals that yielded those profits. City-CUB Ex. 2.0 at 22, L. 529-43; Staff Ex. 13.00 at 7-8, L. 150-57. Absent the repeated misuse of Peoples Gas' PGA assets and costs, enovate's miraculous $20 million in reconciliation period profits are inexplicable.

In addition, CUB witness Mierzwa and Staff witness Rearden described how – in deals like the one called "Manlove Jumpstart" – Peoples Gas imprudently transferred gas from its Manlove storage facility to Enron affiliates during the record cold winter of 2000-2001, and then was compelled to replace that gas for its customers on the spot market or under the GPAA, at higher prices. CUB Ex. 2.0 at 7, L. 9-16; Staff Ex. 3.00 at 56 L. 1477-87. Under Manlove Jumpstart, Peoples Gas transferred substantial amounts of gas from storage to Enron Midwest during the last 10 days of November 2000. Staff Ex. 3.00 at 56, L. 1477-78; Staff Ex. 7.00 at 53, L. 1123-25. During the same 10-day period, Peoples Gas purchased identical amounts of gas at record high spot market prices from EMW. Staff Ex. 3.00 at 56, L. 1478-1482; Staff Ex. 7.00 at 53-54, L. 1138-41. This was a direct and blatant transfer of wealth from Peoples Gas (and its

ratepayers) to Enron Midwest, with Peoples Gas' customers left to pick up the tab. *See*, Staff Ex. 3.00 at 56, L. 1489-96; Staff Ex 7.00 at 53-54, L. 1128-45.

4. Individual Deals

The major transactions discussed above resulted in tens of millions of dollars in imprudent costs for customers. In addition, Staff identified other smaller but noteworthy transactions that expose the insidious nature of the deals and arrangements Peoples Gas accepted. Through these arrangements, the Enron and Peoples Energy corporate families split the gains from their abuse of the utility's PGA assets and costs. An Enron affiliate often served as a sham middleman to hide utility-affiliate transactions that lacked Commission approval.

The plainest example is the refinery fuel gas or RFG deal. Before the GPAA, Peoples Gas purchased RFG directly from an affiliate of Citgo Petroleum at a significant discount off of the first of month index price. Staff Ex. 9.00 at Attach. B. To effect the RFG deal during the reconciliation period, the cooperating entities took the following steps. (1) Peoples Gas did not renew its direct purchase arrangement with Citgo. *Id*. at 11-12, L. 286-89. Instead, (2) PERC, a Peoples Gas affiliate, purchased the RFG from the refinery at the same discount off the first of month index price that Peoples Gas enjoyed previously. *Id*. at Attach. B. (3) PERC then sold the RFG to Enron Midwest – at a substantial profit, but still below the first of month index price. *Id*. Finally, (4) Peoples Gas bought the gas from EMW – with yet another mark-up, but still below the FOM index price. *Id*. Incredibly, Peoples Gas asserted it should be applauded because ratepayers benefitted from its actions; after all, ratepayers still got the gas for less than 100% of the FOM index price! PGL Ex. L at 47, L. 1045-46.

5. Consequences of the Enron Strategy

Fortunately for ratepayers, whether costs are prudent and reasonable is not determined by a simple comparison to the highest price some other utility may have paid or to some measure of market price. The circumstances in which the utility's decision or action was taken are an essential element of the prudence determination. Where those circumstances offer the utility an economic opportunity that better serves its ratepayers, merely beating the price paid by another utility or paying a market index price demonstrates neither reasonable costs nor prudent management.

This common sense understanding of the prudence requirements of Section 9-220 is codified in Section 525.40 of the Commission's rules, which prohibits utility actions that increase customers' gas charge. 83 Ill. Admin. Code §525.40(d). Revenues derived from transactions that are supported by recoverable gas costs "must be credited to ratepayers as an offset to the costs recovered through the Gas Charge." *Id*. Thus, a utility may not freely divert or decline revenues and revenue opportunities to evade this regulatory treatment of the revenues from transactions supported by recoverable gas costs. Diversions of revenues that a reasonable business would pursue, and that, if taken, would lower the Gas Charge are not prudent.

The economic harm to ratepayers from Peoples Gas' Enron related deals was in the tens of millions of dollars. The cooperative scheme among the Enron and Peoples Energy corporate families has already diverted millions in potential cost savings or offsetting revenues to entities beyond the Commission's regulatory directives. PGL used ratepayer dollars to fill the economic hole created by the Enron-Peoples Energy schemes. All that remains for complete success of the

scheme is to put their tentative gains forever beyond the reach of regulators through an order approving Peoples Gas' proposed reconciliation.

The Commission should not allow that to happen. Instead, the Commission should disallow the improper costs resulting from Peoples Gas' participation in its parent's Enron Strategy. The principal imprudent costs of Peoples Gas' improper decisions and actions are identified in the record.

Dr. David Rearden, testifying for the Staff, used a "bottom-up" approach to estimate ratepayer harms from the GPAA. Dr. Rearden quantified the harm from only those individual GPAA transactions that Staff was able to reconstruct in detail from the documents provided in discovery. He estimated the harm to ratepayers from that subset of GPAA activity at more than $13 million. Staff Ex. 7.00 at 36, L. 765-66. City-CUB expert witness Lindy Decker used a "top-down" approach that compared the costs of gas paid under the GPAA to the sum of transportation costs and gas prices for several gas supply hubs available to Peoples Gas as alternative supply sources. She estimated the overall harm from all GPAA transactions in FY 2001 at nearly $38 million. City-CUB Ex. 2.0 at 4, L. 118.

The ALJ denied PGL's final attempt to find support for the claimed prudence of the GPAA. Specifically, she refused to take administrative notice of the gas changes of other Illinois utilities, stating "I just don't think what other companies do is relevant." Apr. 21, 2005 Tr. at 1335-36. Peoples Gas' burden is not to show that other gas utilities (in the circumstances they faced) may have paid more, but to demonstrate that its own decisions and actions were prudent in the circumstances pertinent to Peoples Gas. Peoples Gas has not met that burden.

Both City-CUB witness Lindy Decker and Staff witness Dianna Hathhorn recommend that the utility refund approximately $20 million in potential cost offsets that were diverted to enovate. City-CUB Ex. 1.0 at 66, L. 188-89; Staff Ex. 9.00 at 19-23, L. 450-529; Staff Ex. 9.00 at Sch. 9.05, Sch. 9.06. The available evidence, assembled and presented by Staff and GCI, show that those profits were the result of a misuse of Peoples Gas' PGA assets and costs that had a dramatic and direct impact on the costs collected from utility ratepayers. Ratepayer bills increased because of Peoples Gas' decisions that denied utility ratepayers the benefits of opportunities for offsetting revenue that the utility effectively transferred to affiliated entities. Absent credible evidence that establishes another source for enovate's extraordinary profits, those potential cost offsets to PGA charges must be credited to Peoples Gas ratepayers.

D. Gas Lost and Unaccounted For

Besides the Enron-related transactions, City-CUB witness Decker discovered and reported a dramatic increase in the utility's gas lost and unaccounted for ("GLU") in FY 2001. Ratepayers incurred substantial imprudent costs as a result of this unexplained spike in the quantities of gas lost and unaccounted for. City-CUB Ex 1.0 at 38, L. 1085-97; at 41, 1159-72.

Testimony from Peoples Gas challenged certain quantitative elements of Ms. Decker's testimony, and Peoples Gas claimed that its performance (GLU percentages this time) was not the worst among utilities. PGL Ex. K at 4, L. 69-74, at 6-7, L. 108-29. Peoples Gas' witness Zack argued that its GLU numbers fell within the broad range of GLU percentages reported by other gas utilities. *Id*. at 6-7, L. 108-29. While such comparisons might show that Peoples Gas did not have the worst GLU numbers ever experienced, they say little or nothing about prudence,

since they do not take account of the distinctive circumstances of the reporting utilities. Ultimately, PGL's testimony only confirms the unexplained explosion of GLU costs in the reconciliation year, an effect of apparent management imprudence for which no other cause has been identified.

In any case, the dispute over which set of numbers to use ultimately did not matter, since the utility's inability to explain away its gas management failures and its admissions regarding the effect of its management imprudence make a compelling case.

- Peoples Gas never denied that a dramatic and unexplained increase in its GLU occurred in FY 2001. Whichever set of numbers one uses, the magnitude of the increase (more than 400%) is similar and startling. City-CUB Ex. 2.0 at 25, L. 613-14.

- Peoples Gas never denied that FY 2001 PGA charges to ratepayers were higher because of the unexplained GLU increase.

- The utility's own documents and testimony confirm the spike in GLU and the associated gas costs. In the words of Peoples Gas' employees, the utility's GLU "skyrocketed". Other internal correspondence refers to "runaway GLU." Zack Cross Ex. 1; Zack Cross Ex. 2.

- In Peoples Gas' own internal documents, the market cost of the utility's GLU is estimated to be $40 million. City-CUB Ex 2.0 at 31, L. 751-53; City-CUB Ex. 2.16.

Peoples Gas does nothing to explain the more than 400% increase in the quantity of lost gas in the reconciliation period or the proportionate increase in costs to ratepayers. Peoples Gas has failed to meet its statutory burden of proving that the costs of increased lost gas were reasonable and prudently incurred.

E. Failure to Hedge Gas Price Risk Exposure

Peoples Gas' imprudent, FY 2001 procurement-related decisions included the utility's refusal to hedge the gas price risk exposure of its captive customers. In fact, Peoples Gas did not even have an effective price risk management plan in place for the reconciliation period. City witness John Herbert testified that that management failure was itself imprudent. City Ex. 1.0 at 43, L. 1094. Mr. Herbert and CUB witness Brian Ross testified that Peoples Gas was again imprudent in failing to respond to the observably volatile price environment of 2000 and 2001. *See*, *e.g.*, City Ex. 1.0 at 43-44, L. 1103-113; CUB Ex 1.0 at 15. Peoples Gas rejected any use of readily available and commonly used hedging tools to mitigate gas price volatility risk – and the resulting ratepayer exposure.

Peoples Gas' decisions and conduct on behalf of its customers contrast sharply with the actions of prudent businesses operating in the same price environment. The utility's unregulated affiliates, for example, hedged extensively during the reconciliation period, on behalf of shareholders, to protect their revenues. City Ex. 1.0 at 26-28, L. 640-94; CUB Ex 1.0 at 9-10. enovate engaged in speculative trading to profit from the very volatility Peoples Gas ignored. Peoples Energy, the utility's parent company, used exotic financial hedges like weather insurance to protect its shareholders from revenue volatility, while Peoples Gas rejected mainstream wholesale market hedges as too risky, leaving ratepayers unprotected. City Ex. 1.0 at 27, L. 682-89; CUB Ex 1.0 at 9. Using the decisions of its affiliates as a benchmark of prudent business behavior during that period, Peoples Gas' failure to protect its customers by hedging was clearly imprudent. In short, Peoples Energy and its unregulated affiliates managed the gas price and revenue risk exposure of their investors very effectively, but Peoples Gas left its captive

customers completely exposed to the increased price volatility of the 2000-2001 gas commodity market. Mr. Ross estimated the harm from PGL's failure to hedge

Peoples Gas' professed trepidation about the supposed risks % of its winter requirements at about $50 million. Mr. Herbert, looking at a prudent hedging strategy for the utility's minimum necessary winter purchases, estimated about $230 million in harm. Peoples Gas' professed trepidation about the supposed risks of hedging, absent detailed instructions and a virtual guarantee against risk from the Commission, is neither credible nor supported by the record. The Commission's regulations specifically provide for recovery of price risk management costs. 83 Ill. Admin. Code §525.40(a)(4). Peoples Gas has provided no evidence that it actually evaluated changes in gas price volatility to manage price risk, and it thus fails to meet its burden of proof.

F. Customers Were Harmed

The City, CUB, the AG, and the Commission Staff all assert that Peoples Gas' prudent, recoverable gas costs cannot be reconciled with the amounts it collected from ratepayers in FY2001. But it is Peoples Gas' burden to demonstrate that the costs it charged to ratepayers were prudent and reasonable. Despite Peoples Gas' assertions to the contrary, the record shows that ratepayers were harmed, and the harm was substantial.

II. LEGAL ISSUES

A. Peoples Gas Bears The Burden of Proof on All Issues

Section 9-220 of the PUA provides for an annual examination of the PGA costs of each utility collecting gas charges under that provision.

> [In the] public hearings to determine whether the clauses reflect actual costs of fuel, gas, power, or coal transportation purchased to determine whether such purchases were prudent, and to reconcile any amounts collected with the actual costs of fuel, power, gas, or coal transportation prudently purchased . . . [T]he burden of proof shall be upon the utility to establish the prudence of its cost of fuel, power, gas, or coal transportation purchases and costs.

220 ILCS 5/9-220(a). This provision unequivocally places the burden of proof on all material issues squarely and exclusively on the utility.

By this express statutory mandate, Peoples Gas has the burden of demonstrating that the costs it recovered through FY2001 Gas Charge collections were reasonable, prudently incurred, and accounted for as prescribed by Commission regulations. Where Peoples Gas fails to meet that burden as to all essential elements of its case, the Commission must then adjudicate the measure of harm to ratepayers from the utility's imprudent or otherwise improper conduct. Staff and interveners do not bear the burden of proof as any to issue.

As to certain of Peoples Gas' costs, Staff and GCI presented compelling evidence that the utility recovered costs that were neither reasonable nor prudently incurred. Peoples Gas must rebut such evidence, or the Commission cannot approve its reconciliation.

A necessary corollary of Peoples Gas' statutory burden of proof is that if the record lacks proof on any relevant issue, the utility fails to rebut substantive evidence of imprudent or unreasonable costs, or the utility's testimony is ambiguous, unclear, or simply not credible, then

Peoples Gas has failed to meet its burden. Moreover, any deficiency of proof must be weighed against Peoples Gas. This is the only lawful framework for the Commission's consideration of the evidence presented.

On the record before the Commission, Peoples Gas has utterly failed to meet its burden of proof.

B. The Proper Scope of PGA Proceedings Is Broad

1. The Pertinent Case Law Rejects Peoples Gas' Narrow Reading of Section 9-220 and Mandates A Broad Reconciliation Investigation

Peoples Gas has repeatedly asserted that the scope of this case is limited to a narrow examination of the prudence of purchases the utility made specifically for its PGA customers. *See*, *e.g.*, PGL Ex. K at 12, L. 244-46 (Staff witness Hathhorn's and City-CUB witness Decker's recommendations regarding enovate "[have] no relationship to the subject matter of this proceeding, which is limited to the prudence of [Peoples Gas'] gas costs that it recovered through the Gas Charge during the reconciliation year." Illinois courts have held that the proper scope of reconciliation proceedings cannot be so narrowly construed. *Bus. & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n*, 171 Ill. App. 3d 948, 957-58 (1st Dist. 1988) (*BPI v. ICC*). The scope of fuel adjustment clause or PGA proceedings encompasses non-procurement actions of the utility that affect – even indirectly – the PGA or FAC charges paid by ratepayers.

The courts have found that there are non-procurement actions of a utility that can cause fuel prices for customers to be higher than they prudently should have been. In *BPI v. ICC*, the First District affirmed the Commission's order that Commonwealth Edison Company (ComEd)

be required to refund approximately $70 million that it had collected through its fuel adjustment charge (FAC).[4] *Id*. at 971. The Commission found that imprudent, non-procurement, utility actions led to increased costs that were recovered through reconciliation period fuel adjustment charges. Those increased costs were disallowed in an annual reconciliation proceeding.[5]

On appeal, ComEd argued that the refund order was unlawful because it went beyond the Commission's jurisdiction under Section 36, the predecessor section to Section 9-220. In particular, ComEd argued that Section 36 did not permit the Commission to review plant performance as part of a fuel reconciliation proceeding. The utility argued that "the Commission's jurisdiction in a fuel reconciliation proceeding is limited to determining whether a utility made prudent purchases of power." *Id*. at 956-57.

The court rejected ComEd's interpretation of the Commission's authority under Section 36. The court first noted that "section 36 demonstrates a grant of broad discretion to the Commission by the legislature." *Id*. at 957. The court then stated that

> under ... the Public Utilities Act ... the Commission had authority to inquire into production management in determining whether fuel purchases were "prudently" made. To conclude otherwise would result in an extremely narrow interpretation of a broad grant of statutory power and ***would also defy common sense***.

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[4] The FAC is Illinois' regulated electric utility analog to the gas utility's purchased gas adjustment clause. Both clauses are implemented under and controlled by Section 9-220 of the PUA.

[5] The $70 million refund in that cased flowed from the poor performance of ComEd's LaSalle 1 nuclear unit.. In a rate proceeding in which LaSalle 1 was put into rate base, ComEd told the Commission that the plant would run at a 60% capacity factor in 1983. *Bus. & Prof'l People*, 171 Ill. App. 3d at 955. However, the plant operated at less than an 18% capacity factor. The Commission concluded that the utility's 60% capacity factor prediction for LaSalle 1 in 1983 was imprudent and ordered ComEd to refund approximately $70 million in replacement power costs, which represented the difference between the cost of fuel actually incurred and the cost of fuel that would have been incurred had the nuclear unit operated at the predicted 60% capacity factor. *Id*. at 955-56.

> If, in a fuel reconciliation proceeding, the Commission could not examine the reasons that necessitated a fuel purchase, the prudence standard would have no effect on ensuring a just and reasonable rate as required by [S]ection 36 . . . a utility could generate electricity in any manner it chose, efficiently or inefficiently, and the Commission would be limited to determining merely whether the utility paid a prudent price for the fuel. We do not believe that this was the intent of . . . our State legislature . . . in enacting the fuel adjustment clauses legislation.

Id. at 958 (emphasis added).

Like ComEd in the *BPI v. ICC* case, Peoples Gas posits the same myopic view of the scope of FAC or PGA reconciliation proceedings. Also like *BPI v. ICC*, this case concerns not just imprudent gas purchases, but also the consequences to ratepayers of non-procurement utility conduct. Especially with respect to the enovate transactions, Peoples Gas argues that the scope of this case – and thus the limit of the Commission's authority – is confined to determining whether the gas costs Peoples Gas passed through its PGA were prudent. When the *BPI v. ICC* court rejected such a pinched interpretation of Section 9-220, as "defy[ing] common sense," it held that costs of imprudent, non-procurement, utility actions that increased the Section 9-220 costs charged to ratepayers were properly disallowed. *Id*.

Here, certain transactions during the reconciliation period – like the enovate and hub transactions – that, while not gas costs that Peoples Gas flowed through the PGA, had an effect on what ratepayers paid. As such, these transactions are within the scope of this case and are relevant to the Commission's decision in this matter. Testimony of record from the City, CUB, the AG, and the Commission Staff examines the full range of Peoples Gas activities that affected reconciliation period PGA costs. The Commission must consider the full range of evidence in

determining whether Peoples Gas' gas procurement practices were prudent and whether its unusual arrangements with various unregulated Enron and Peoples Energy affiliates' diverted offsets to, or increased, the PGA costs collected from the utility's ratepayers in FY 2001.

2. A Broad Investigation Is Similarly Required By the Commission's Orders and Regulations Implementing Section 9-220

In this proceeding, Peoples Gas has questioned the relevance to the reconciliation proceeding of the numerous "Hub" and enovate transactions examined in the testimony of Staff and GCI witnesses. *See*, *e.g.*, PGL Ex. K at 12, L. 244-46. Peoples Gas also attempted to justify its refusal to hedge the gas price risk to which it its captive ratepayers faced by pointing to an alleged uncertainty about recovery of the costs of price management. PGL Ex. H at 21, L. 606-07. The relevance of a utility's wholesale transactions and its authority to recover price management costs flow directly from Commission orders and the directives codified in Section 525.40 of the Commission's regulations.

a. Docket 78-0457 – Commission Order Implementing the Fuel Adjustment Clause

The predecessor to Section 9-220 permitted, but did not obligate, the Commission to adopt an FAC for electric utilities and a PGA for gas utilities. In Docket 78-0457, the Commission considered the question of whether to implement a uniform FAC for electric utilities.

In accepting a uniform FAC, the Commission worried that "passing costs forward through the FAC . . . remove[s] incentives for utilities to bargain for the lowest procurement

prices." 45 Pub. Util. Rep. 4th at 19. To protect customers under these changed conditions, the Commission stressed: "It is absolutely essential, if fuel adjustment clauses are to be used correctly, that the manner by which a utility acquires, handles and accounts for fuel supplies be wholly prudent and defensible." *Id*. at 22.

Peoples Gas' actions in this case did not meet the Commission's standard of "wholly prudent and defensible" conduct.

b. The Express Language of Part 525 Requires An Examination of All Peoples Gas Transactions Supported By Gas Charge Collections.

In Docket 94-0403, the Commission ordered certain modifications of its regulations implementing the PGA provisions of PUA Section 9-220. *See* Dkt. No. 94-0403, 1995 Ill. PUC LEXIS 579 (Ill. Commerce Comm'n Aug. 23, 1995). The Commission's revision of Part 525 recognized "changes initiated at the federal level ... have substantially changed the way gas utilities procure supply and capacity resources." 1995 Ill. PUC LEXIS at 3. "The revisions to Part 525 ordered in this rulemaking will provide the necessary flexibility for utilities to reflect these industry changes in their monthly gas charge filings ...." *Id*. at 4.

The Commission also found that reconciliation proceedings are the proper venue for examining "utilities' design day planning and the way that utilities have used their supply and capacity in off-system transactions." *Id*. at 28. These transactions include "capacity releases, sales for resale, buy/sell transactions and exchanges" – and "all types of gas costs – [including] reservation and commodity charges." *Id*. at 8, 24.

The Order also concluded that prudent management of gas supply and storage capacity might require economic use of certain PGA assets or costs to reduce charges to ratepayers.

> [W]hile the Commission agrees with CUB, as do some utilities, that some level of capacity release may be a part of prudent management of gas supply and capacity management, the level of capacity release needed to meet the prudence standard has not been explored in this proceeding and is not susceptible to definition in a rule.

Id. at 37.

Under a variety of unusual arrangements between Peoples Gas and utility and Enron affiliates, opportunities for Peoples Gas to realize revenue that could offset PGA costs were foregone or diverted to affiliated firms. The Staff's and GCI's examinations of those activities are well within the scope of the reconciliation proceedings contemplated by the Commission. Whether particular actions or instances of inaction were prudent requires a thorough examination of the relevant circumstances developed in this record.

With respect to the hedging costs at issue in this proceeding, the Commission was as clear as it was for off-system transactions. In the explicit language adopted, the costs of prudent price management (hedging) activities are among Section 9-220's "recoverable costs." The definition of "recoverable gas costs" was revised to include, *inter alia*, "other out-of-pocket direct non-commodity costs related to hydrocarbon procurement, transportation, supply management, or price management." 83 Ill. Admin. Code §525.40(a)(4). Ultimately, the Commission concluded: "The gas supply market is in transition and the types of options available to utilities are changing. The definition of 'recoverable gas costs' should be broad enough to accommodate that change." *Id*. at 7.

The inclusion of price management costs in the definition of "gas costs" is central to the assessment of Peoples Gas' argument that it would not be prudent to hedge without prior Commission approval. It is also the basis for the City's and CUB's examination of Peoples Gas' price management activities.

The Recoverable Gas Costs gas utilities may recover through the Gas Charge must, however, be **offset "by the revenues derived from transactions** at rates that are **not subject to the Gas Charge(s) if any of the associated costs are recoverable gas costs** as prescribed by subsection (a)." 83 Ill. Adm. Code §525.40(d) (emphasis added). That is, if (1) the prices at which a transaction is completed are non-PGA rates and (2) any of the costs associated with the transaction are Recoverable Gas Costs, then the revenues from any transaction supported by PGA costs must be credited to ratepayers as an offset to collections through the Gas Charge. The only exceptions are transactions that are subject to ICC tariff regulation. *Id*. Further, Section 525.40(d) expressly requires gas utilities to refrain from "entering into any such transaction that would raise the Gas Charge(s)." *Id.*

This prohibition provision does not – as Peoples Gas seems to assume – authorize a gas utility to be indifferent to ratepayers' interests as long as it does not act affirmatively to increase the Gas Charge. A utility may not freely divert to others, or simply decline to pursue for itself and its ratepayers, revenues or prudent and reasonable revenue opportunities, with the objective of avoiding regulatory treatment of any revenues earned. Apr. 21, 2005 Tr. at 1317. Under Section 525.40, a gas utility may not deny or neglect to give ratepayers the economic benefit of revenue opportunities provided by the costs they bear.

Peoples Gas maintains that a reconciliation proceeding is a series of very narrow tasks – a simple review of actual purchases; a comparison of claimed costs to actual collections; and an arithmetic exercise to compute any difference between costs and collections. *See* PGL Ex. K at 12, L. 244-46. Illinois law provides otherwise. *Bus. & Prof'l People*, 171 Ill. App. 3d at 958. Any activities that affect Peoples Gas' recoverable gas costs are properly within the scope of the case.

c. Application of Section 525.40 in This Case

Peoples Gas' hub services include firm and interruptible transportation and storage services, as well as park and loan services.[6] Peoples Gas' provision of these services was supported by PGA assets and costs.

- The Company used PGA gas from its Manlove storage field and Mahomet pipeline in displacement transactions[7] and otherwise, to support its hub services. Peoples Ex. F at 41, L. 912-914;

- The Company's hub services were supported by stored PGA gas made available through PGL's storage operations.

Hub services transactions, therefore, are subject to the revenue offset provisions of Section 525.40. Peoples Gas admits that it did not flow revenues from hub services through its Gas Charge. PGL Brief on §525.40 at 10 (Mar. 4, 2005); PGL Pre-Hearing Memo at 11 (Feb. 25, 2005).

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[6] Park and loan services refer to short-term storage (parking) and short-term withdrawals (loaning) of natural gas.

[7] For a discussion of "displacement transactions," *see e.g.*, Staff Ex. 2.00 at 31-38, L. 675-781; Staff Ex. 6.00 at 26-34, L. 529-700; Staff Ex. 1.00 at 10-14, L. 209-306; Staff Ex. 5.00 at 10-13, L. 239-284.

Peoples Gas also engaged in activities that it maintains "optimized" "excess" PGA gas assets, storage capacity, and operations. City-CUB Ex. 2.0 at 44, L. 1259. For instance, the Company contracted for the optimization of a no-notice, contract storage service known as NSS pursuant to its Storage Optimization Contract with Enron Midwest. The costs of the Company's optimization arrangements are recovered through the Gas Charge. Staff Ex. 7.00 at 49, L. 1358-60. Because ratepayers' supply of gas was not interrupted, Peoples Gas suggests that its use of available PGA gas (and related transport and storage activity) to support midstream transactions does not require Section 525.40 treatment.

Despite acknowledging this involvement of PGA costs, the Company argues that its "hub transactions are fully supported through the use of assets, such as Manlove Field and the Mahomet transmission pipeline, for which all associated costs are recovered through Peoples Gas' base rates, and not through the Gas Charge." PGL Second Pre-Hearing Memo at11, L. 219-223 (emphasis added). However, Peoples Gas has presented only its conclusory assertions. It has not validated that claim with accounting or documentary evidence showing details of the questionable transactions.

All evidence relevant to determining whether the offset provisions of Section 525.40 must be applied to particular transactions is properly examined in this proceeding. Narrowing the mandated examination of issues in the manner suggested, by Peoples Gas or otherwise is not permissible.

C. Credibility and the Burden of Proof

All parties presented substantial evidence in this case. Much of the material evidence introduced by PGL, however, is not credible. As the trier of fact, the Commission should give no weight to unreliable evidence.

"The credibility of expert witnesses and the weight to be given their testimony are matters for the Commission as the trier of fact." *Ill. Bell Tel. Co. v. Ill. Commerce Comm'n*, 327 Ill. App. 3d 768, 777 (3rd Dist. 2002), *citing Lefton Iron & Metal Co. v. Ill. Commerce Comm'n*, 174 Ill. App. 3d 1049 (1st Dist. 1988). *See also Cent. Ill. Pub. Serv. Co. v. Ill. Commerce Comm'n*, 243 Ill. App. 3d 421, 443 (4th Dist. 1993). "The weight accorded an expert's opinion must be measured by the facts supporting the opinion and the reasons given for his or her conclusions. If an expert's opinion lacks a factual basis, the opinion deserves little weight." *Doser v. Savage Mfg. & Sales*, 142 Ill. 2d 176, 195-96 (1990); *Temesvary v. Houdek*, 301 Ill. App. 3d 560, 568 (2nd Dist. 1998); *St. Paul Fire & Marine Ins. Co. v. Michelin Tire Corp.*, 12 Ill. App. 3d 165, 179 (1st Dist. 1973) (expert testimony is "of value only when it is based upon and in harmony with facts which are capable of verification by the court"). Further, expert testimony impeached by physical exhibits introduced into evidence should receive little weight. *St. Paul Fire & Marine Ins. Co.*, 12 Ill. App. 3d at 179.

As demonstrated below, PGL's positions and evidence on several core issues lack credibility and are entitled to little or no weight. Relying heavily on such evidence, Peoples Gas fails to meet its burden of proving the prudence of its decisions and actions in this proceeding.

1. PGL's Refusal to Produce Relevant enovate-Related Information Until Compelled Raises an Issue of Credibility

Peoples Gas' refusal for nearly two years to respond meaningfully to data requests relating to enovate and non-tariff transactions exemplifies the utility's lack of credibility. Because PGL is not credible, it cannot satisfy its burden of proof to show that costs recovered through the Gas Charge were prudently incurred.

In August 2002, Staff moved to compel PGL to respond fully to two data requests relating to PGL's affiliate, enovate, and to non-tariff transactions. In particular, Data Request ENG 2.081 sought detailed information on any business relationships between PGL's affiliates and enovate. Staff DR ENG 2.081. Peoples had responded:

> Respondent had no business relationship with enovate during the reconciliation period. The business relationships, if any, between Respondent's affiliates and enovate are beyond the scope of this proceeding, which is the reconciliation of Respondent's gas costs and revenues subject to its Rider 2. Accordingly, Respondent objects to this data request.

PGL Resp. to Staff DR ENG 2.081. In supplemental response, however, PGL acknowledged that is affiliate, Peoples MW, LLC was a member of the Midwest Energy Hub - which became enovate - and that "enovate purchased services from Respondent pursuant to Respondent's Operating Statement on file with and approved by the Federal Energy Regulatory Commission." *Id.*

Data Request ENG 2.082 sought a list of all daily natural gas transactions between PGL's affiliates and entities that engaged in off-system transactions with PGL during the reconciliation period. Peoples Gas responded that third parties that engaged in such off-system transactions

> have no obligation to advise Respondent of their intended disposition of the gas that Respondent sold to them. Moreover, such transactions by those third parties are beyond the scope of this proceeding . . . Accordingly, Respondent objects to this data request.

Staff Mot. To Compel at Attach. A (Jul. 30, 2002). In its motion to compel, Staff noted that during the reconciliation period, EMW exercised a call option requiring PGL to sell it natural gas, but that PGL received revenues associated with the option sale from enovate that were not passed on to ratepayers. Staff added that PGL's responses to related data requests "show that [PGL] is inextricably intertwined with Enron Midwest LLC and enovate LLC." Staff Mot to Compel at 2-4 (Jul. 30, 2002). Accordingly, Staff explained, PGL's failure to respond meaningfully to ENG 2.082 "severely limit[ed] the Commission's ability to determine whether Peoples [Gas] acted prudently or possibly used . . . off-system customers to engage" in transactions that harmed PGL ratepayers. *Id.*

PGL opposed Staff's motion to compel, arguing that it could not be compelled to produce documents not within its possession and control; the company, in its opinion, already had produced adequate information for purposes of prudence review and further delays were unwarranted. PGL Resp. to Staff Mot. To Compel at 3-11 (Aug. 7, 2002). In an attempt to resolve the discovery dispute, PGL requested, and was granted, leave to file additional direct testimony on issues "that are the focus of the discovery" sought by Staff's data requests. Aug. 28, 2002 Tr. at 8. PGL filed additional direct testimony, but continued to withhold information regarding enovate and non-tariff transactions.

On February 3, 2004, CUB moved to compel PGL to respond fully and accurately to ENG 2.081 and ENG 2.082, citing FERC-maintained Enron documents that called into question

the accuracy and completeness of PGL's responses to those requests.[8] CUB Mot. to Compel at 5 (Feb. 3, 2004). CUB explained that the new information revealed a significant business relationship between PGL and enovate; a storage agreement involving enovate/PGL Hub; and a profit sharing agreement between PERC and Enron for non-tariff transactions that used ratepayer assets. *Id*. CUB also pointed to authority holding that documents within the possession of an affiliate or sister corporation are discoverable under the circumstances of this case. *Id.* at 6-9.

In response, PGL attempted to minimize the significance of Enron e-mails from the reconciliation period evincing a close and extensive relationship between enovate, PGL, and its affiliates that involved, *inter alia*, a profit sharing agreement as well as use of ratepayer assets and PGL personnel. PGL Resp. to CUB Mot to Compel at 6-10 (Feb. 5, 2004). PGL's evasion of its obligation to provide meaningful information relating to enovate ceased only after the ALJ reopened discovery in February 2004 to allow Staff and GCI to pursue the "reasonable line of inquiry" reflected in ENG 2.081 and ENG 2.082. Feb. 10, 2004 Tr. at 133.

The absurdity of PGL's objections to the relevance of non-tariff transactions and the relationship between PGL, its affiliates, and Enron became clear once the utility finally produced Enron-related information.[9] When confronted with evidence of apparent misuse of PGA resources, PGL offered no explanation supported by documentary evidence as to how enovate generated over $20 million in income for fiscal year 2001. Moreover, PEC and Enron appear to

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[8] Staff and the City subsequently joined CUB's motion to compel.

[9] That PGL ultimately produced enovate-related information does not suggest it satisfied its discovery obligations. Indeed, PGL never produced requested enovate-related ledger information that would have allowed Staff and GCI to "follow transactions among the PEC and Enron affiliates from beginning to end, verify the economic substance of specific transactions, and sicern the working relationships of the parties." City_CUB Ex. 1.0 at 78, L. 2183-87.

have tried to circumvent the Commission's restrictions on affiliate transactions by using Enron's employees to conduct enovate's activities - the joint venture never had employees of its own. City-CUB Ex. 1.0 at 69, LL 1952-56.

In light of this evidence, PGL's continuing challenge to the relevance of PGL's relationship with Enron betrays a stunning lack of credibility. PGL's testimony regarding enovate and other Enron affiliates is entitled to no weight, and PGL has failed to show prudence.

2. PGL's Repeated Claims That It Did Not Conduct an Economic Analysis of the GPAA Are Wholly Disingenuous

PGL has the burden of demonstrating that its actions in procuring gas were prudent. 220 ILCS 5/9-220. The GPAA dominated PGL's gas supply procurement during the 2000-2001 reconciliation period. To demonstrate that the GPAA was prudent, PGL relies on testimony that lacks credibility and that cannot support a Commission determination in the utility's favor. Because PGL's testimony on the prudence of the GPAA is wholly incredible, PGL has not met its burden of proof.

Whether PGL conducted an economic analyses of the proposed GPAA before signing the contract is a key issue in this proceeding. PGL consistently denied that it performed any quantitative analysis before signing the GPAA. Staff requested analyses of the GPAA numerous times throughout discovery. *See* Staff Data Requests ENG 2.68, 2.74, 2.75, and 2.88. In response, PGL claimed generally that no such analyses existed and specifically provided no calculations, studies, or analyses. *See* PGL Resp. To Staff DRs ENG 2.68, 2.74, 2.75, 2.88. Additionally, several PGL witnesses consistently denied that they knew of or conducted any

economic analysis of the GPAA during negotiations.[10] Despite the assertions of three high-level PGL employees, at least two analyses of the proposed GPAA did exist - the "Aruba" analysis and the analysis found in PGL employee David Wear's files (Wear Cross Exhibit 15, hereinafter "Wear analysis"). Uncovered among the millions of pages of documents produced by PGL during discovery, these two analyses demonstrated - at the time they were created - that the GPAA would have a negative impact on ratepayers.

The Aruba analysis forecasted gas prices both with and without the GPAA, and concluded that ratepayers would pay higher prices under the GPAA. The Wear analysis is an historical comparison between the prices PGL - and its captive ratepayers - would have paid from 1995 to 1999 had the GPAA been in effect. PGL clearly conducted and then apparently completely ignored two quantitative analyses that demonstrated the GPAA likely would have a negative effect on ratepayers. PGL's assertions of prudence in entering the GPAA thus are not credible and are entitled to no weight.

Moreover, the Aruba and Wear analyses directly contradict PGL's repeated assertions that no economic analysis was performed. In fact, not only do the analyses impeach PGL's claims that no such analyses existed, but the substance of the analyses directly contradicts PGL's assertions that entering the GPAA was prudent. The evidence clearly demonstrates that PGL did

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[10] In his pre-filed rebuttal testimony, PGL witness David Wear stated, "there were no written, quantitative studies to determine the effect that the GPAA might have on gas costs." PGL Ex. F at 14, L. 303-04. Counsel for CUB asked Mr. Wear during his deposition, "you stated that the company didn't do any such analysis, any written quantitative analysis or study of the GPAA prior to it going into effect; is that right?" Wear Dep. At 36, L. 13-16. Mr. Wear answered: "To my knowledge that is correct." *Id.* At line 17. Moreover, William Morrow, PGL's Vice President of Gas Supply and the executive who signed the GPAA on behalf of PGL, responded in deposition that he was not aware of anyone within PGL being asked to perform or prepare an economic study of the GPAA. Morrow Dep. At 45-46, L. 17-20. These individuals were (and are) high-level PGL employees who were involved in negotiating the GPAA on PGL's behalf.

in fact perform at least two analyses of the potential effects of the GPAA before signing that contract, both of which unequivocally showed that entering the GPAA would raise PGA costs. As such, PGL's repeated assertions that no analysis existed are wholly disingenuous and completely lacking in credibility. PGL thus has completely failed to meet its burden of proof to show that entering the GPAA was prudent.

3. PGL Witness David Wear Is Not Credible

PGL witness David Wear is particularly incredible. Mr. Wear is PGL's current Manager of Gas Supply Administration, and is responsible for "negotiating, contracting, and dispatching the assets that make up the gas supply portfolio of PGL." PGL Exhibit B at 1, L. 7, 9-10. Mr. Wear played a central role in negotiating the GPAA. Apr. 20, 2005 Tr. at 1009. Further, Mr. Wear is PGL's key witness on several key issues in this proceeding; most notably the GPAA, enovate, the Storage Optimization Contract, management of storage and non-tariff transactions, and the utility's failure to hedge. *See, generally,* PGL Ex. B, C, F, L, O. As the utility's chief witness on these major issues, Mr. Wear's utter lack of credibility eviscerates PGL's claims of prudence.

As noted above, Mr. Wear has throughout this proceeding flatly denied the existence of a quantitative analysis of the GPAA, despite overwhelming evidence that he did, in fact, conduct at least one such analysis before PGL entered the contract. Evidence introduced by Staff and GCI demonstrates that Mr. Wear should have been aware of at least one additional quantitative analysis of the GPAA's likely effect on ratepayers, and as a result should have known that more than one analysis concluded that the GPAA would have a negative impact on ratepayers. *See*

City-CUB Ex. 1.0 at 17-18, L. 512-26. For these reasons, Mr. Wear's testimony is not credible and should be given no weight by the Commission.

Mr. Wear claimed repeatedly that he did not conduct a quantitative or economic analysis of the GPAA during negotiations. During the evidentiary hearings, Mr. Wear initially continued to deny that he performed any quantitative analysis of the GPAA. Apr. 20, 2005 Tr. at 1009-10. Later, during re-direct examination, however, Mr. Wear claimed that he *was* involved in analyzing substantial portions of the GPAA. *Id.* at 1081. This statement directly contradicts all previous statements made by Mr. Wear, and demonstrates very clearly his total lack of credibility.

But perhaps most damaging to Mr. Wear's credibility is the Wear analysis, which leaves little doubt that Mr. Wear did in fact conduct a quantitative analysis of the GPAA only twelve days before the contract was signed. *See* Wear Cross Ex. 15. Indeed, the document admitted as Wear Cross Exhibit 15 clearly is a quantitative analysis of the GPAA. *See id.* As the ALJ noted during the evidentiary hearings, that analysis "is remarkably similar to the table that Mr. Wear had prepared as Exhibit No. 8 to his supplemental … direct testimony, Respondent's Exhibit C." Apr. 20, 2005 Tr. at 1054. Although Mr. Wear claimed to have no memory of creating the Wear analysis, GCI adduced compelling evidence that Mr. Wear created the document. *See* May 26, 2005 ALJ Ruling. As discussed by the ALJ in her written ruling admitting the Wear analysis, the document was created on Mr. Wear's user-named and password-protected computer, and was located in a folder created by Mr. Wear. *Id.* at 1, Apr. 20, 2005 Tr. at 1036-46. That Mr. Wear now claims to have no memory of creating the document does not allow him to escape either the existence or the substance of the analysis. The Wear analysis belies PGL's and Mr. Wear's

repeated contentions that PGL conducted no quantitative analysis of the GPAA prior to signing the contract, and establish that Mr. Wear's testimony is unworthy of credence. *See* May 26, 2005 ALJ Ruling at 2.

As contradicted by Mr. Wear's own testimony at the April 20, 2005 evidentiary hearing and by the Wear analysis itself, Mr. Wear's pre-filed testimony, discovery responses, and deposition are rife with distortions and false assertions. Clearly, Mr. Wear, PGL's chief witness on virtually all issues in this proceeding is hopelessly incredible and the Commission must discount his testimony in its entirety. Because Mr. Wear's testimony is entitled to no weight, PGL is utterly unable to meet its burden to show prudence.

III. THE EVIDENTIARY RECORD

A. GPAA Imprudence

On September 16, 1999, William Morrow, PGL's Executive Vice President of Gas Supply, signed a 5-year gas supply contract with Enron North America ("ENA"). This contract, titled the Gas Purchase Agency Agreement ("GPAA"), provided roughly 66% of the natural gas supply requirements of Peoples Gas during the reconciliation period and represented by far the largest cost item for the utility. Staff Ex. 2.00 at 16, L. 112-15. PGL witness David Wear admitted that prior to the GPAA, it was Peoples Gas' regular business practice to purchase gas from several parties in a series of smaller volume contracts with terms ranging from four months to five years. PGL Ex. C, at 4, L. 65-67; Staff Ex. 2.00 at 8-9, L. 183-99; City-CUB Ex. 1.0 at 14, L. 401-12. The GPAA represented a dramatic departure from Peoples Gas' previous procurement practices. Staff Ex. 2.00 at 8-9, L. 180-81, 200-04.

The GPAA allowed ENA, in its sole discretion, to act unilaterally to set the price or volume of large portions of the gas supplied under this contract. *See, e.g.*, City-CUB Ex. 1.0 at 11-12, L. 294-311. Yet for this single largest contract for its single largest cost item, Peoples Gas repeatedly claimed that it had conducted no economic analysis prior to signing the GPAA to determine whether the contract was economically advantageous for the utility and its ratepayers. Staff Ex. 6.00 at 6, 8.

Both City-CUB witness Decker and Staff witness Anderson correctly concluded that Peoples Gas' claim that it did not conduct an economic analysis of a proposed contract of this magnitude is itself compelling evidence of imprudence. City-CUB Ex. 2.0 at 9, L. 204-05; Staff Ex. 2.00 at 12, L. 258-61; Staff. Ex. 6.00 at 5-6, L. 100-09. An overhaul in gas purchasing practices such as undertaken by PGL requires quantitative studies and analysis to support the decision -- as well as competitive bidding, which PGL did not undertake. Staff Ex. 6.00 at 5-6, L. 100-09. Peoples provided no *contemporaneous* studies showing that entering the GPAA was prudent. *Id*. at 6, L. 112-15. Although Peoples Gas claimed that the GPAA was so complex that it would have been "next to impossible" to perform any economic analysis, (PGL Ex. F at 2, L. 36-38), Mr. Anderson noted that Peoples Gas simply could have negotiated a less complicated contract. Staff Ex. 6.00 at 13, L. 255-56. Moreover, it is absurd to claim that a company as large and sophisticated as Peoples Gas lacked the ability to determine if the largest gas purchase contract in its recent history would have *any* economic benefit for the utility or its ratepayers.

Nevertheless, PGL's purported justification for failing to conduct an economic analysis of the GPAA is no longer relevant, other than to demonstrate the utility's total lack of credibility. It is now clear that Peoples Gas *did*, in fact, conduct at least two pre-signing economic analyses of

the GPAA that the utility concealed during discovery. These undisclosed economic analyses show that Peoples Gas knew at the time it signed the GPAA that it was an imprudent business deal that would increase gas costs for its ratepayers by millions of dollars.

1. Peoples Gas' Pre-Signing Economic Analyses

a. *Economic Analysis #1: Roy Rodriguez's Aruba Analysis*

Among the millions of pages of documents produced by PGL after discovery was reopened in February 2004 was an economic analysis of the GPAA titled the "Aruba Analysis." *See* Staff Stipulation, sheets 50-74. The analysis was prepared by Mr. Roy Rodriguez, a manager in Peoples Energy's Risk Management group, in August and September of 1999, prior to the signing of the GPAA. Staff Ex. 7.00 at 9, L. 263, 287. Employing both high and low case scenarios, Mr. Rodriguez analyzed how the GPAA provisions would compare to Peoples Gas' historical practice of purchasing field gas and transporting it to Chicago.[11] Under both scenarios, the Aruba Analysis showed that the GPAA provisions would result in higher gas costs for ratepayers. City-CUB Ex. 1.0 at 18, L. 523-26. Mr. Rodriguez stated that he discussed this analysis with David Wear (Supervisor of Gas Supply Administration), Raulando DeLara (Managing Director of Gas Supply) and Charles Blachut (Manager of Gas Supply Planning). *Id.* at 18, L. 539-42.

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11 Mr. Rodriguez determined the GPAA cost of gas as the Chicago citygate first-of-month price minus 3¢, where the citygate price was computed as a forecast of the NYMEX Henry Hub price plus the forecasted Henry Hub-Chicago basis differential data attached to Mr. Wear's Direct Testimony as Exhibit 2. Mr. Rodriguez determined the non-GPAA cost of gas as the NYMEX cost of gas in the field, plus the forecasted field to Henry Hub basis differential data attached to Mr. Wear's Direct Testimony as Exhibit 2 and the variable cost of transportation to Chicago, using pipeline tariffs. Staff Ex 7.00 at 13, L. 263-70.

b. *Economic Analysis #2: Wear's GPAA Loss Analysis*

Shortly before evidentiary hearings commenced, the City discovered, among the millions of pages of electronic discovery, yet another pre-signing analysis of the GPAA. Specifically, the City uncovered a document found in the electronic files of PGL's head of Gas Supply Administration, David Wear. The electronic file properties showed that the file was authored and last modified by Peoples Gas' manager of Gas Supply Administration, David Wear, within weeks before the GPAA was signed. Apr. 20, 2005 Tr. at 1011. This document, introduced into evidence as Wear Cross Exhibit 15, compared the actual gas costs for the years 1996 through 1999 with the costs that would have been incurred had the GPAA been in effect. As the ALJ described the GPAA Loss Analysis,

> [f]or approximately 11 months during this period, the figures in the "Enron North America Proposal" column are less than those in the "Actual PGL" column. For the remaining 37 months, the figures in the "Actual PGL" column are less than those in the "Enron North America Proposal" column. In short, purchases made through terms found in the GPAA cost more than what is represented to be past purchase practices.

May 26, 2005 ALJ Ruling at 1. In fact, Wear Cross Exhibit 15 showed that, for three out of the four years analyzed, the GPAA would have cost ratepayers as much as $29.9 million in one year more than Peoples Gas' past purchase practices. Wear Cross Exhibit 15 predicted that, in total, the GPAA would have cost ratepayers over $50 million more than Peoples Gas' past purchase practices.

Despite the utility's attempts to denigrate Mr. Rodriguez's analysis and Mr. Wear's professed inability to recall creating the "backcast" analysis, the fact remains that, at the time

Peoples Gas decided to enter the GPAA, every economic analysis of the GPAA known to Peoples Gas showed it to be an unfavorable deal for the utility and its captive ratepayers. There is no reasonable or prudent basis for Peoples Gas' outright rejection of the analyses' consistent, cautionary results.

2. Peoples Gas' Professed Rationale For Signing the GPAA Does Not Withstand Scrutiny.

Mr. Wear absurdly asserts that entering the GPAA was prudent because it met five factors the utility purportedly used to evaluate a supply contract, even though Peoples Gas has not produced any documentary evidence that these five factors were actually considered. Staff Ex. 6.00 at 15, L. 293. In particular, Mr. Wear's *post hoc* rationalization asked whether the GPAA: (1) would preserve the value of PGL's transportation capacity assets basis; (2) would have market-based commodity pricing with no reserve or demand charges; (3) would have flexible pricing terms; (4) would provide flexibility to meet various weather conditions; and (5) would be a reasonable proxy for historic gas supply contracts. PGL Ex. C at 10-11, L. 216-24. Yet, Mr. Wear also testified that "the five major supply criteria … had been met under historic purchase practices." PGL Ex. F at 15, L. 326-27. Mr. Wear added that "the only significant changes in the GPAA from its historical purchasing practices were the process of arriving at the GPAA and a desire by the Company to protect its transportation assets from the damaging effects of a potential dramatic decline in basis." *Id.* at 10-11, L. 218-21.

a. *The GPAA Was Unnecessary to Protect the Value of Peoples Gas' Firm Transportation Assets.*

Mr. Wear testified that Peoples Gas concluded, before signing the GPAA, that the difference between the price of natural gas at various trading points and the price of gas at the Chicago citygate, known as the basis differential, was likely to shrink. Thus, Peoples Gas reasoned, the value of its transportation rights between these gas trading points and the Chicago citygate were also likely to decline. PGL Ex. C at 6, L. 109-14; PGL Ex. F at 15, L. 311-14. Although Mr. Wear asserted that the GPAA "included some assurance about recovery of the value of [PGL's] underlying transportation assets," (PGL Ex. C at 8, L.150-152), PGL never showed that there was, in fact, a declining basis.

To demonstrate that Peoples Gas was concerned about a declining basis before signing the GPAA, Mr. Wear referred to several tables and reports, which were attached to his Additional Direct Testimony as Exhibits 2 and 3. *Id.* at 7-8, L. 144-64. However, Mr. Rodriguez used the same data contained in Wear's Exhibits 2 and 3 in the Aruba Analysis, and concluded that the GPAA was a bad deal for ratepayers. Apr. 19, 2005 Tr. at 939; Staff Ex 7.00 at 13, L. 255-71.

In addition, Mr. Wear's assertions regarding a declining basis are retrospective. In particular, his conclusion that basis would have declined by slightly more than 1 cent per MMBtu per year was reached *after* the GPAA was executed. PGL Ex. C at 8-9, L. 171-73. And Peoples Gas has not presented any evidence that this type of determination was made *prior to the execution of the* GPAA.

Nor does Mr. Wear's retrospective analysis stand up to scrutiny. First, in Wear Cross Exhibit 1, Mr. Wear maintained that PGL could not provide any calculations supporting the claimed $.01/MMBtu decline in basis. In fact, on cross-examination, Mr. Wear characterized his own trend analysis, used in his sworn testimony, as "simply one way to show a general trend." Apr. 19, 2005 Tr. at 899.

Second, basis differentials vary on a seasonal basis, and the tables with monthly data indicate that the basis is consistently higher in months November through March than the months April through October. *Id.* at 898. Yet, each of the monthly data charts starts with five out of the six data points at the seasonal peak (November through March) and ends with seven data points at the seasonal low (April through October). *Id.* This choice of starting and ending points skews the results to show a decline in basis. As Mr. Wear acknowledges, "anytime you change the data set, you're going to get different results." *Id.* at 899. But Mr. Wear did not test the validity of his trend line analysis with different starting and ending points. *Id.* at 899-900. Thus, Mr. Wear's analysis does not show that Peoples Gas' assertion that basis differentials were falling was reasonable.

Third, Mr. Rodriguez's more thorough Aruba analysis used Mr. Wear's basis forecasts (PGL Ex. 2 & 3), but in a different way than Mr. Wear testified. The Aruba analysis showed that, regardless of the basis forecasts, the GPAA would cost ratepayers more than Peoples Gas' previous purchasing methods.

Finally, Peoples Gas did not point to any other basis differential data, beyond that provided in Mr. Wear's testimony, that was considered prior to entering the GPAA. Mr. Wear cited supposed concerns about "the damaging effects of a potential dramatic decline" greater than

the $.01/MMBtu per year discussed above. PGL Ex. F at 11, L. 220-21, 224, 529-30; Apr. 19, 2005 Tr. at 892. Mr. Wear admitted, however, that scenarios illustrating more dramatic potential declines were "not part of this record or presented in this case." Apr. 19, 2005 Tr. at 944-45.

b. *The GPAA Was Not A Prudent Precaution Against Mr. Wear's Claimed Basis Decline.*

Peoples Gas asserts that a decline in transportation basis differential would have affected the overall cost of gas to ratepayers in two ways. First, the basis between the field and the Chicago citygate could shrink to a point where it would be less expensive to buy at the citygate price than to purchase gas at the field and transport it to Chicago. PGL Ex. F at 6, L. 114-17. Second, Peoples Gas' ability to optimize its transportation assets – that is, to earn revenue from those assets when they were not being used to serve PGL ratepayers – would decline as the basis declined. PGL Ex. C at 9, L. 185-88. Even accepting Mr. Wear's $0.01 basis decline trend, neither possibility supports Peoples Gas' decision to enter the GPAA.

Optimization is a secondary purpose of transport assets; as Mr. Wear agreed, Peoples Gas does not enter into transport agreements specifically so that it can optimize that transport capacity. Apr. 19, 2005 Tr. at 906-07. Moreover, Mr. Wear valued the transportation assets transferred to ENA at $2.7 million.[12] This is less than 0.7% of the more than $572 million value of the contract for the reconciliation period. Assuming that PGL's basis analysis is correct, tying

[12] Mr. Wear states that "[t]he 3¢ credit [applicable to the baseload and SIQ] produced savings to customers during the reconciliation period of $2.7 million [and] was the mechanism by which [Peoples Gas] guaranteed value for its transportation assets and offset the expected decline in basis." PGL Ex. C at 16, L. 347-50.

the decision of whether to enter into a $2 billion contract to such a small fraction of the contract value was not prudent.

c. *Mr. Wear's Other Concerns Were Met By Peoples Gas' Previous Purchasing Practices Or Otherwise Fail To Justify Entering the GPAA.*

Mr. Wear testified that one reason for entering the GPAA was to achieve market-priced pricing with no demand or reservation charges. PGL Ex. C at 10-11, L. 217-18. However, under the GPAA, Peoples Gas paid all pipeline capacity costs, despite giving the majority of it away to Enron, and implicitly being charged again for transportation in citygate prices. Staff Ex. 2.00 at 20, L. 427-31. As to demand charges, Staff witness Anderson stated:

> Peoples has [] failed to break down the cost components of the GPAA contract to establish that it is not paying a demand charge for the load swing capability of the GPAA. Merely stating that no swing load demand charges are incurred does not convince Staff that these costs are not imbedded in the GPAA.

Staff Ex. 2.00 at 20, L. 438. Peoples has not rebutted this reasonable inference from the GPAA's terms.

The GPAA's "Flexible Pricing" and "Base Load Pricing Adjustment" terms provide flexible pricing, but solely to the seller, allowing Enron to raise the cost of gas to Peoples Gas' ratepayers. The GPAA provides flexibility for Peoples Gas only if Enron agrees to the price changes. Flexible pricing was a concern only because Peoples entered a 5-year contract for 66% of its supply. Peoples Gas historically used smaller, shorter contracts, which provided a level of flexibility that Peoples Gas has not shown the GPAA matches. Staff Ex. 6.00 at 23, L. 466-72.

The GPAA also allows Peoples Gas to buy additional gas and sell back excess gas as needed. However, Peoples Gas needed that flexibility because the GPAA used normal weather

to establish its baseload contract quantities. Consequently, Peoples Gas would have more supply than needed when the weather is warmer than normal. Staff Ex. 6.00 at 21, L. 438-39.

3. Individual Provisions of the GPAA

Independent of Mr. Rodriguez's and Mr. Wear's analyses, expert witnesses for Staff, the AG, the City, and CUB found that the terms of the GPAA alone were a bad deal for ratepayers. Staff Ex. 12.00 at 12, L. 257; AG Ex. 1.1, at 8-9, L. 8-16; City-CUB Ex. 1.0 at 4, L. 100, 242. Under the GPAA, Peoples Gas ceded to Enron control over how much gas the utility would buy, when it would buy gas, and the price it would pay for that gas. City-CUB Ex. 1.0 at 4, L. 242. Ms. Decker provided a global analysis of the detrimental effect of the GPAA on Peoples' ratepayers, and concluded that the "economic harm caused ratepayers during the reconciliation period because of GPAA imprudence was $37,470,517." City-CUB Ex. 1.0 at 7, L 207. AG witness Effron addressed specific provisions of the GPAA, and his disallowance figures accompany the discussion of those provisions below.

Under the GPAA, Peoples Gas was obligated to purchase two specific quantities of gas: 1) the Baseload Quantity ("Baseload"); and 2) the Summer Incremental Quantity ("SIQ"). In addition, Peoples Gas had the option to purchase a Daily Incremental Quantity ("DIQ") of gas.

a. Baseload Quantity

The GPAA required ENA to supply PGL with a specified Baseload quantity of gas at the Chicago First of Month[13] Index ("FOM") minus three cents in each month of the term of the

[13] [redacted]

(continued...)

GPAA. PGL Ex. C at 216, L. 332-34. During the reconciliation period, Baseload ranged from [redacted] MMBtu per day in January and February of 2001 to [redacted] MMBtu per day in September 2001. AG Ex. 1.0 at 4, L. 13-15. The GPAA also contained two separate provisions that allowed ENA to change -- unilaterally -- the price of portions of the Baseload Quantity that Peoples Gas was required to buy. Staff Ex. 2.0 at Attach. 1 at 1.

b. Baseload Price Adjustment ("BLPA")

Under the Baseload Price Adjustment ("BLPA") of the GPAA, ENA could change the price of up to [redacted] MMBtu per day of the Baseload from FOM-$.03 to the [redacted] during the months December through March ("Winter Period"). *Id.* The BLPA provided ENA with two alternative means to profit from price volatility, at ratepayers' expense. First, whenever the Daily Price exceeded the FOM, the BLPA allowed ENA to purchase all of the baseload supply at FOM and reprice [redacted] MMBtu per day at the higher Daily Price. AG Ex. 1.0 at 8-9. Second, ENA could purchase [redacted] MMBtu per day at the Daily Price and the remainder of the baseload volume at the FOM, allowing ENA to profit if the FOM Price exceeded the Daily Price and break even when the Daily Price was higher than the FOM Price. AG Ex. 1.0 at 8, L. 14-17. Under each of these scenarios, ENA benefitted from its decisions to shift between the FOM and Daily citygate prices, and PGL ratepayers paid higher prices.

AG witness Effron determined that the value of the BLPA to ENA during the reconciliation period was $4,925,000. AG Ex. 1.0 at 15, L. 21. Any evaluation of the prudence

(...continued)
[redacted]

of signing the GPAA must take account of this cost to ratepayers. Although ENA ultimately did not exercise the BLPA, it did not forego the potential profit .

The volumes and the financial effect of a deal designated "Transaction 19" are similar to the effect of implementing the BLPA. AG Ex. 1.0 at 10, L.13. Transaction 19 was an off-system transaction in which Peoples Gas agreed to sell [redacted] MMBtu of baseload to ENA at the FOM price for each day in December 2000. Peoples Gas provided a planning document to support its assertion that the transaction was justified by a predicted over-supply situation in December. AG Ex. 1.1 at 11-16. [redacted] However, [redacted] *Id.* at 12, L. 20.

As it happened, the utility's supply was short in December 2000. As a result of Transaction 19, Peoples Gas needed to replace the [redacted] sold to ENA with an equal volume of purchases at the Daily Price, costing Peoples Gas $5,472,000. *Id.* at 11, L. 8. Indeed, the average price Peoples Gas paid [redacted]/MMBtu) to obtain spot gas supplies to

[14] Peoples Gas did not provide any written agreement memorializing Transaction 19. Apr. 19, 2005 Tr. at 920; Wear Cross Exhibit No. 5. As Mr. Wear testified, "to not have a written contract of this type of a contract or this type of transaction in general is atypical." Apr. 19, 2005 Tr. at 920-21.

cover ratepayer demand was actually higher than the average Daily Price in December 2000. *Id.* at 11 n.5.

c. Flexible Pricing

Under the GPAA's Flexible Pricing provision, ENA was entitled to change a block of xxxxxx MMBtu per day and/or [redacted] MMBtu per day of Baseload from the FOM-$.03 to the Daily Price-$.03 during the Winter Period. These two provisions could be exercised together, allowing ENA to reprice up to [redacted] MMBtu per day from the FOM-$.03 to the Daily Price-$.03 during the Winter Period. Staff Ex. 2.00, Attach. 1 at 10. By changing the price to track changes in the market, ENA could assure that the price in effect at any time would be the one to its advantage – and, consequently, to ratepayers' disadvantage. City-CUB Ex. 1.0 at 9, L. 269-70. Granting this substantial unilateral power to ENA was not a prudent decision. *Id* at 10, L. 276-77.

d. Summer Incremental Quantity

The GPAA also required ENA to supply Peoples Gas with an additional Summer Incremental Quantity ("SIQ") at FOM -$.03 for the months April through November ("Summer Period"). PGL Ex. C at 16, L. 340-41. The volume of the SIQ would be determined by ENA, subject to the minimum and maximum quantities specified in the agreement. Staff Ex. 2.00, Attach. 1 at 6. This provision of the GPAA gave Peoples Gas no control over the SIQ volumes that it was required to purchase from ENA.

Mr. Wear testified that "Peoples was indifferent to when these volumes showed up to

some degree, because that quantity would over the summer period [be] expected to average out to somewhere in the middle and that quantity of gas would have been used for storage refill." City-CUB Ex. 1.0 at 12, L. 323-26 (internal quotations omitted). But as Ms. Decker testified, if the "above average SIQ purchases were required during high price periods and were 'balanced' by below average SIQ purchase quantities during low-price periods, the prices paid by ratepayers would not 'average out to somewhere in the middle,' and PGL should not have been 'indifferent to when those volumes showed up.'" *Id.* at 13, L. 368-72.

Moreover, the analysis performed by Mr. Effron found that "[t]he SIQ option provided more than a mere possibility that ENA 'could' benefit." AG Ex. 1.1 at 7, L. 13. The SIQ option virtually guaranteed that ENA would benefit. On days when the Daily Price was higher than FOM -$.03, ENA could deliver the minimum SIQ of [redacted] MMBtu. On the other hand, on days when FOM -$.03 was higher than the Daily Price, ENA could acquire up to [redacted] additional MMBtu at the Daily Price and then "put" that volume to Peoples Gas at FOM -$.03. AG Ex. 1.1 at 7, L. 15-22.

In practice, the SIQ option worked almost exactly as Mr. Effron's analysis indicated. ENA acted rationally to maximize its profit. Thus, with only minor exceptions, when the FOM -$.03 was greater than the Daily Price, the SIQ was [redacted] MMBtu, and when the FOM -$.03 was less than the Daily Price, the SIQ was [redacted] MMBtu." AG Ex. 1.1 at 9, L. 16.

e. Sell Back Provision

Peoples Gas could also resell to ENA up to [redacted] MMBtu per day at the Daily Price less [redacted] to [redacted], depending on the volume and the timing of the nomination of gas being

resold to ENA. The price Peoples Gas received for gas sold back decreased with higher volumes and less notice to ENA.

Peoples Gas witness Wear referred to the sell back ability as "a key factor in negotiating the pricing terms" of the GPAA, and a useful responsive tool for excess gas when Peoples was in an over-supply position. PGL Ex. C at 24, L. 513-20. Nevertheless, on over 70% of the days when ENA delivered the maximum SIQ to Peoples Gas, the utility was compelled to sell gas back to ENA at a loss because it simply did not need the quantity of gas the GPAA forced it to take. *See* City-CUB Ex. 2.0 at 13, L. 292-99. The sellback provision simply reflected an oversupply condition created or exacerbated by ENA's unilateral elections under the SIQ provision.

f. The Discount

Peoples Gas' attempts to link the 3¢ FOM discount on Baseload and SIQ purchases under the GPAA to a number of contractual benefits the GPAA gave ENA are meritless. Mr. Wear claimed that the discount "guaranteed value for its transportation assets and offset the expected decline in basis," but Peoples Gas has introduced no evidence that it performed any valuation of its transportation assets *before signing the GPAA*. PGL Ex. C at 16, L. 348-50.

Second, Peoples has stated that by agreeing to the BLPA, it obtained a discount of 3¢ rather than 2¢. Wear Cross Ex. 3. There is no evidence, however, that Peoples Gas conducted any analysis showing that the 1¢ discount was fair compensation for inclusion of the BLPA. Finally, Peoples Gas witness Frank Graves characterized the 3¢ discount as a "demand credit that offsets the SIQ optionality and other contract terms giving flexibility to Enron." PGL Ex. H at

34, L. 1006-08. This *post hoc* rationalization comes from a witness who did not participate in evaluating the GPAA before it was executed. In any case, the single discount provision cannot be the consideration for all these terms that were unfavorable to ratepayers.

B. Because Peoples Gas' Hub Transactions Were Supported By PGA Assets and Costs, The Associated Revenues Should Offset PGA Costs

Under 83 Ill. Admin. Code § 525.40(d), Peoples Gas is required to offset PGA costs with revenues from non-tariff transactions supported by recoverable gas costs. Peoples Gas bears the burden of showing that the costs it passed through the PGA were prudently incurred and calculated in accordance with the Commission's rules. 220 ILCS 5/9-220(a). With respect to hub transactions, Peoples Gas is required to demonstrate that it complied with the PGA Clause. Peoples Gas has failed to carry this burden, and it should be required to refund to ratepayers its revenues from hub transactions.

It is undisputed that Peoples Gas' hub transactions are conducted at rates not subject to the Gas Charge. *See* PGL Brief on §525.40, at 13-14 (Mar. 4, 2005). They are conducted at rates contained in a FERC-approved Operating Statement, not in Commission regulated tariffs. *Id.* at 10. Therefore, the exemption in section 525.40(d) for "transactions subject to rates contained in tariffs on file with the Commission, or in contracts entered into pursuant to such tariffs," does not apply to Peoples Gas' hub transactions.

The core dispute in this case with respect to hub revenues is whether *any* of the costs associated with hub transactions is a "recoverable gas cost" – that is, a cost PGL recovered from ratepayers through the PGA. Peoples Gas bears the burden of establishing that the recoverable

gas costs it collected through Gas Charges were not associated with its hub services. Rather than make this showing, Peoples Gas has relied almost entirely on the unsupported testimony of David Wear that only base rate assets (Manlove storage field in particular) are involved in hub transactions. *See* PGL Ex. C at 33, L. 721-29.

Even assuming the say-so of Mr. Wear were sufficient to meet PGL's burden – which it is not – Peoples Gas has failed to rebut Staff's testimony that Peoples Gas regularly uses displacement of gas in storage to conduct hub transactions and, therefore, uses recoverable gas costs in doing so. In addition, the utility has on occasion used PGA gas to complete hub transactions when it did not have sufficient non-PGA gas supply. Throughout the reconciliation period, Peoples Gas operated its storage facilities in a manner that gave hub deals valuable, preferential access to available PGA stored gas.

As explained by Staff witness Dennis Anderson, displacement permits the "movement of natural gas through a pipeline system without the physical delivery of the same molecules of natural gas." Staff Ex. 2.00 at 32, L. 679-81. For example, if Peoples Gas plans to inject 1,000 units of gas into Manlove for PGA system supply on a given day, and performs a non-tariff transaction on the same day that requires the withdrawal of 10 units of gas, Peoples Gas physically injects only 990 units of PGA system supply into Manlove, using the other 10 units to complete the hub transaction. The displacement occurs when Peoples Gas makes an accounting entry for the 10 units of PGA system supply gas it could have injected into Manlove. *Id.* at 32, L. 682-94. As Mr. Anderson testified, displacement accounts for Peoples' ability to continue withdrawing gas for hub customers even after the non-tariff inventory in Manlove field is exhausted. Staff Ex. 2.00 at 37, L. 772.

The use of PGA gas in displacement transactions allows Peoples Gas to arrange hub deals without incurring costs of physically transporting gas to the hub customer, or having the hub customer arrange transportation. *Id.* At 38, L. 785-95. Those costs avoided by using gas injected into storage to serve ratepayers or operation of PGL's system to complete the deal increase net revenue for the hub.[15] *Id.* at 39, L. 809-13. Diverting to unregulated affiliates of PGL and Enron those revenues supported by Peoples Gas' storage inventory leaves ratepayers with the costs, but not the benefits, of that use of PGA assets and costs.

In addition, when the non-tariff inventory of stored gas turned negative in January 2001 – that is, after hub customers had removed more gas from Manlove than they injected into it or otherwise had in the field, Peoples Gas provided PGA gas from storage to enable completion of the hub transactions. *Id.* at L. 773-81. To the extent storage inventory could have been, but was not, used to serve ratepayers in the winter of 2001, when spot market prices reached record highs and the GPAA indexed prices rose, ratepayers incurred additional imprudent costs. *See* City-CUB Ex. 1.0 at 49, L. 1406-11. Section 525.40(d) bars a utility from engaging in such non-tariff transactions that raise the Gas Charge. Finally, the availability of PGA gas for hub transactions is like a call option for the Peoples Gas hub. That option has value, just like a financial call option, and the PGA gas and operations made available support the utility's hub services.

PGL admits that hub transactions use displacement of gas in storage. PGL Brief on §525.40, at 14 (Mar. 4, 2005). Mr. Anderson testified that displacement is not possible without using recoverable gas costs, and Peoples Gas has not shown otherwise. Staff Ex. 2.00 at 33, L. 708; Staff Ex. 6.00 at 27, L. 551. The cost of gas "purchased for injection into the gas stream" is

[15] Peoples Gas' hub operations would incur more costs if it had to arrange transportation or distinct supplies.

a recoverable gas cost under the Commission's rules. The cost of system supply gas is still a recoverable gas cost when the gas is used in displacement for a hub transaction. 83 Ill. Admin. Code § 525.40(a)(1). In addition, the cost of leased pipeline or capacity storage, which also is used in displacement, (Staff Ex. 2.0 at 39, L. 811-13), is a recoverable gas cost under section 525.40(a)(2) of the Commission's rules. Thus, the hub transactions are supported by recoverable gas costs and must be offset by the associated revenues.

Peoples Gas attempts to excuse its diversion of hub revenues by citing alleged benefits to ratepayers from the injection of third party gas into Manlove for hub transactions. In particular, Peoples Gas witness Thomas Puracchio testified that the addition of such third party volumes into Manlove extended Manlove's decline point – that is, the point at which a given daily withdrawal rate can no longer be met. PGL Ex. M at 8, L. 154-60. Under cross-examination, however, Mr. Puracchio was unable to identify any *economic* benefit to ratepayers associated with the extension of Manlove's decline point. Apr. 18, 2005 Tr. at 681-82. Because the injection of third party gas into Manlove did not lower the Gas Charge, PGL's claim that captive customers benefitted from hub transactions is irrelevant to this proceeding. Moreover, Peoples Gas should not be permitted to rely on this claim to mask its diversion of the actual economic benefit – that is, hub revenues – to which ratepayers are entitled under section 525.40(d).

PGL maintains that under several Commission decisions, hub revenues should be treated as an adjustment to operating income in setting base rates rather than flowed through the PGA. PGL Brief on §525.40 at 14-17 (Mar. 4, 2005). PGL's reliance on those decisions is, however, misplaced.

Two of the decisions did not even address whether revenues from hub and other services

not subject to tariffs on file with the Commission should be included in base rates or the Gas Charge. Indeed, *Northern Illinois Gas Company*, Docket No. 93-0320, 1996 Ill. PUC LEXIS 151 (Mar. 13, 1996), simply rejected the utility's contention that hub revenues should be split between the utility and ratepayers, maintaining the Commission's policy of passing the entire amounts to ratepayers. It was in the context of rejecting NiGas' revenue sharing proposal that the Commission made the statements on which Peoples Gas relies: that "[r]evenues from the operation of the Chicago Hub should be treated above-the-line," and agreed with Staff that "revenues derived from a utility asset reflected in rates are generally treated above-the-line." *Id.* at *11.

The question of whether the revenues should be flowed through the PGA or included in base rates was not before the Commission. Similarly, in Nicor Gas' 1995 rate case, the Commission simply reiterated its prior holding that hub revenue must be passed on to ratepayers rather than split between shareholders and ratepayers. *Northern Ill. Gas Co.*, Docket No. 95-0219, 1996 Ill PUC LEXIS 204 at *33-35 (Apr. 3, 1996). On a record barren of any evidence or arguments on the issue, the Commission could not, as a matter of law, have ruled on such matters outside the record. 220 ILCS 5/10-103.

As to the two other Commission decisions, no party argued in either case that hub revenues should flow through the PGA, because hub transactions are supported by PGA recoverable costs through the displacement of gas. In fact, there were no intervenors in either case, and Staff did not oppose the utilities' requests. *See N. Ill. Gas Co.*, Docket No. 03-0551 (Nov. 12, 2003); *N. Ill. Gas Co.*, Docket No. 02-0779 (Feb. 20, 2003). In this case, by contrast, the Commission is confronted with Staff and GCI's testimony on PGL's use of the displacement

and actual withdrawal of PGA gas in generating hub revenues. The Commission's regulations require that the associated revenues be used to offset PGA costs. PGA reconciliation proceedings are adjudicated based on the evidence of record and the parties' arguments in the particular case. 220 ILCS 5/10-103.

None of the Commission decisions cited by PGL is outcome determinative in this case, which must be decided based on the particular facts and arguments in this record. To be sure, prior Commission decisions may inform consideration of the legal issues in this case. But Peoples Gas has not cited the most informative Commission decision addressing the proper treatment of hub revenues. In *Central Illinois Light Co.*, Docket No. 00-0710 (Feb. 6, 2002), the Commission rejected CILCO's argument that management fees it earned in providing various services to non-jurisdictional customers need not be passed on to ratepayers even though those services included supplying gas to those customers. *Id.* at 8-9. CILCO argued that unlike revenues from supplying gas to non-tariff customers, the management fees were not associated with any recoverable gas cost and, accordingly, were not subject to section 525.40(d)'s offset requirement. *Id.* at 2-5. Because section 525.40(d) applies if *any* of the costs associated with non-jurisdictional transactions is a recoverable gas cost, the Commission required CILCO to flow the management fees through the PGA. *Id.* at 8-9. The Commission's decision in that case is consistent with the Commission's rationale for adopting the current version of section 525.40(d): to deter utilities from subsidizing "off-system transactions with on-system transactions," which could increase PGA costs. Dkt. 94-0403, 1995 Ill. PUC LEXIS 579 at *17 (Aug. 23, 1995).

In this case, countenancing Peoples Gas' diversion of hub revenues to enrich its unregulated affiliates at ratepayers' expense would undermine that rationale. Peoples Gas has

offered no evidence or analysis supporting David Wear's bald assertion that "none of the costs supporting [hub transactions] are recovered through the gas charge." PGL Ex. C at 33, L. 726-29; 747-49. And although Mr. Wear maintains that the costs of hub transactions are recovered through base rates, *id.* at 33, L. 743-68, PGL has failed to establish that any of these costs was considered in its last rate case in 1995. In effect, Peoples Gas is asking the Commission to take it at its word. This is entirely insufficient to satisfy Peoples Gas' burden under section 9-220, particularly in light of the unrebutted evidence showing that PGL's hub transactions used PGA assets and costs. *See, e.g.*, City-CUB Ex. 1.00 at 48, L.1369-75; Staff Ex. 2.00 at 39, L. 807-15. Because Peoples Gas has failed to show that its hub transactions during the reconciliation period were not supported by *any* recoverable gas costs, Peoples Gas' hub revenues must be flowed through the PGA.

C. Peoples Gas' Improper Storage and Exchange Activities Produced $51.2 Million In Imprudent Costs

CUB witness Jerome Mierzwa calculated the impact on ratepayers of Peoples Gas' improper storage and exchange transactions. While prices soared during the winter of 2000-2001, the Company withdrew gas from Manlove storage to accommodate the third-party exchange and storage activities detailed above. That is, instead of relying more heavily on gas from storage to serve its sales customers, Peoples Gas had to purchase more high cost gas during the winter of 2000-2001 because gas in storage was utilized to provide third-party exchange and storage services. Peoples Gas withdrew more than [redacted] during the winter of 2000-2001 to accommodate its exchange and storage services. The [redacted] consisted of [redacted] of

gas that Peoples Gas injected into storage on behalf of third-parties prior to the winter of 2000-2001, withdrew and returned that gas to third-parties during the winter of 2000-2001; and an additional [redacted] of gas that PGL withdrew from storage during the winter and delivered to third-parties who returned that gas at a later point in time. CUB Ex. 4.0 at 4-5, L 87-99.

Though Peoples Gas claims that revenues derived from these transactions are properly retained by the Company as base rate revenues (Peoples Response to ENG 2.119, 2.121), the City and CUB maintain that Manlove storage is an asset used to provide bundled services to rate payers under the PGA. Gas assets stored in Manlove and the costs of operating and maintaining the facility are encompassed by the GPA. Those facilities should be used first (or exclusively) to serve and benefit rate payers. Also, revenues earned using those assets and costs must flow through the PGA. In this instance, storage gas should have been utilized to displace high cost purchases, not to serve third parties. It is not unreasonable for Peoples Gas to utilize its storage facilities to generate revenues as long as those storage activities do not increase costs for ratepayers. It is unreasonable and improper for the Company to engage in activities that increase gas costs for ratepayers. *Id*. At 5, L. 100-108.

Staff and CUB both present total recommended adjustments in an attempt to quantify the adverse impact of the Company's storage and exchange activities on the Company's sales customers. CUB witness, Mr. Mierzwa, recommends a total $51.2 million adjustment related to the Company's third party storage and exchange activities. This recommendation is based on the premise that the [redacted] of gas withdrawn from storage during the winter of 2000-2001 to serve third parties could have instead been utilized to displace [redacted] of high cost purchases made by Peoples Gas during the months of November 2000-February 2001. *See* CUB Ex. 1.0 at Schedule

JDM-3. Implicit in this adjustment is the assumption that the [redacted] of gas loaned to third parties during the winter of 2000 - 2001 and repaid at a later date was placed in storage by the Company during the summer of 2000 in anticipation of providing services to third parties. CUB Ex. 4.0 at 9, L.172-175.

The $51.2 million adjustment assumes that the gas withdrawn from storage, which was delivered to third parties during the winter of 2000-2001, was instead delivered to sales customers. CUB Ex. 4.0 at 18, L. 404-413. Thus, the adjustment is based on the difference between gas prices during the summer of 2000, which averaged [redacted], and gas prices at the time gas was delivered to third parties. For example, as shown on Mr. Mierzwa's Schedule JDM-3, in January 2001, the Company withdrew [redacted] of gas from storage that was delivered to third parties. During January 2001, Peoples paid an average of [redacted] for the gas it purchased to serve sales customers. Thus, Mr. Mierzwa's adjustment for January 2001 reflects the difference between the [redacted] cost of gas in January 2001 and the [redacted] cost of gas purchased during the summer of 2000, multiplied by the quantity of gas delivered to third parties during that month. For January 2001 alone, the adjustment was $23.3 million. For the entire winter period, the adjustment is $51.2 million.

D. The Evidence Establishes That enovate's Profits Were the Product of PGA Assets and Costs and Are a Measure of PGL's Diversion of Revenue

As discussed above, section 525.40(d) of the Commission's regulations requires revenues derived from non-tariff transactions to be used to offset recoverable gas costs if *any* of the associated costs are recoverable gas costs. 83 Ill. Admin. Code § 525.40(d). In fiscal year 2001,

each enovate partner (PEC and Enron) realized a **return on investment exceeding 10,000 percent**, reaping $10 million each from their modest $100,000 capital contribution to enovate. City-CUB Ex. 1.0 at 65, L. 1863-67. City-CUB witness Lindy Decker testified that such astronomical earnings are not commonplace in the midstream gas industry, and she pointed to indications that the revenues were attributable (at least in part) to diverted revenues or business from the utility. *Id.* Peoples Gas has not, as section 9-220 of the PUA requires, rebutted evidence that PGA assets and costs were used to generate enovate's massive profits. Those FY2001 profits are a measure of the harm to ratepayers from PGL's imprudent diversion of revenues to enovate, and must be returned to ratepayers.

The evidence in this case leaves no doubt that enovate's ability to generate spectacular profits for PEC and Enron was attributable to the joint venture's peculiar access to and control over PGL's regulated PGA service assets and operations – *viz*., its owned and leased storage capacity, its gas supply, and system injections and withdrawals. In fact, Enron's Annual Report for 2000 made no secret of enovate's control over and use of Manlove storage capacity, publicly proclaiming that Enron had launched a "gas-marketing-services hub in Chicago" with Peoples Energy in March 2000 "[k]nown as Enovate" that "optimizes Peoples' 30 Bcf a year of Chicago-area storage capacity and related transportation." City-CUB Ex. 2.5 at 9. An enovate marketing document entitled, "enovate innovative energy solutions" even characterizes 30 Bcf of storage as an *asset* owned by enovate. City-CUB Ex. 2.6. As Ms. Decker testified, PGL, which bears the burden of proof in this proceeding, has failed to explain how enovate, a company started with a mere $200,000 in capital ($100,000 each from PEC and Enron) shortly before the November 2001 marketing document identified as City-CUB Ex. 2.5 was created could have acquired

control over such a "tremendous amount of storage." City-CUB Ex. 2.0 at 18, L. 423-27. As Ms. Decker concludes, the most plausible explanation – and the only explanation in the record before the Commission – was enovate's preferential access to PGL's assets and operations. *Id*. at 18, L. 427-29.

In addition, Staff and Intervenors introduced compelling evidence that revenues derived from costs paid by PGL ratepayers were diverted through EMW to enovate, both to circumvent the law governing transactions between a public utility and its affiliate, *see* 220 ILCS 5/7-101, and to avoid passing all of the benefits of such transactions to ratepayers. There is no doubt that PGL was well aware of the regulatory requirements for affiliate transactions. An electronic message to William Morrow, who was at the center of PGL's and PERC's midstream (hub) efforts, records:

> [w]e discussed using ENA-MW as a vehicle around affiliate filing in the interim. It was our conclusion that ENA-MW might be set up as Hub customer and market Hub services until ICC approves structure with LLC as administrator and customer of Hub.

City-CUB Ex. 1.33. Similarly, another electronic message, dated February 7, 2000, from William Morrow and PERC employee Roy Rodriguez to PGL senior management, asked the recipients to consider "[w]hat regulatory risk does [sic] the utilities face in avoiding ICC filings on Critical Issue" – apparently referring to, among other things, transactions between PGL and the Chicago Energy Exchange, LLC (which became enovate) – or entering into asset management agreements with its affiliate. City-CUB Ex. 1.32.

The unrebutted testimony of Staff witness Dianna Hathhorn is that "100% of EMW activity in FY01 flowed first to enovate, for subsequent 50/50 sharing with PERC/PEC." Staff

Ex. 9.00 at 9, L. 211-12. Not surprisingly, there is no evidence of any meaningful distinction between enovate and EMW when it came to operations or division of revenues. PERC and EMW provided employees to conduct enovate's activities; enovate never had employees of its own. City-CUB Ex. 1.0 at 69, L. 1952-60; Apr. 19, 2005 Tr. at 794-95. PEC's audit of enovate candidly acknowledges that "*[r]evenue sharing between PEC and Enron related to the optimization of the PGL Hub and the activities of Enron MW (EMW)* are not formally documented.." City-Cub Ex. 2.4 at 2 (emphasis added). The affiliates of Peoples Gas and Enron were the beneficiaries, at ratepayers' expense, of the diversion of revenues to enovate through utility deals and arrangements with EMW.

Two particularly blatant examples of the diversion of revenues through EMW are the Refinery Fuel Gas "RFG" deal and the Storage Optimization Contract "SOC" between PGL and EMW. Both arrangements are described in detail below.

In responding to this substantial evidence of misuse of PGA resources, PGL has offered only vague assertions, unsupported by documentary evidence, regarding the nature of enovate's more than $20 million in FY2001 profits. In particular, PERC President William Morrow has simply averred that "some [unspecified] amount of enovate's income was the product of speculative trading." PGL Ex. N at 5, L. 101-02. In response to a discovery request from Staff seeking details on these claimed speculative trading profits, however, neither Peoples Gas nor PERC were able to substantiate the amount of enovate's speculative trading income, and refused to provide an estimate. Staff Ex. 13.00 at 7-8, L. 152-55. And, as Ms. Decker testified, Mr. Morrow's assertion is "unsupported by any documents that permit verification," let alone the kind of detailed records typically generated in connection with speculative midstream gas

industry trading. City-CUB Ex. 2.0 at 22, L. 537. Customary trading documentation would include each transaction, enovate's counterparties, transaction pricing, and any future commitments. *Id.* at 22, L. 529-40. Indeed, under questioning by ALJ Sainsot, Mr. Morrow admitted that PGL did not provide *any* indication of the amount of enovate's tremendous profits supposedly attributable to speculative trading. Apr. 19, 2005 Tr. at 805.

Nor is Mr. Morrow's unelaborated identification of enovate purchases of non-tariff services from Northern Illinois Gas Company ("NIGAS") and Northern Indiana Public Service Company ("NIPSCO") as a source of earnings worthy of credence. *See* PGL Ex. N at 5, L. 88-91. Mr. Morrow offers *no* details as to the scope or magnitude of such alleged transactions. And when asked to detail the transactions in discovery, Peoples Gas responded that

> PERC ***believes*** that enovate received 305,000 MMBtu of gas from Northern Indiana Public Service Company . . . during May and June of 2001, and it ***believes*** such service was pursuant to [NIPSCO's] Rate Schedule GLS or GPS. PERC ***believes*** that enovate purchased a transportation service from Northern Illinois Gas Company's Hub, ***but it does not know the specifics of the deal***.

City-CUB Ex. 2.8 (emphasis added). As City-CUB witness Lindy Decker put it, "the best that PERC could do was to point to one deal that it knew some specifics about that it believed occurred, and another deal that it believed occurred, but had no specifics about." City-CUB Ex. 2.00 at 20, L. 472-76. Vague descriptions of transactions that may have occurred do not constitute evidence.

To avoid a disallowance of the $20 million of revenues that PGL imprudently diverted to enovate during the reconciliation period, Peoples Gas was required, under the law, to do more than offer unsubstantiated claims of prudence and propriety. Peoples Gas has failed to

demonstrate, as the law requires, that its uses – and the uses it permitted – of PGA assets were prudent, and that enovate's revenues were not associated with PGA assets or costs. Therefore, the Commission should disallow recovery of the $20.7 million in revenues and potential Gas Charge offsets that PGL imprudently diverted to enovate. City-CUB Ex. 1.0 at 66, L. 1887-89.

E. Storage Optimization Contracts

1. Staff's Storage Optimization Contract Adjustment Should Be Adopted

During the reconciliation period, Peoples Gas had firm storage contracts under Natural Gas Pipeline Company's ("NGPL") NSS storage service tariff. Apr. 20, 2005 Tr. at 997. Mr. Wear testified that Peoples Gas only needed the firm storage service for the 10-20 coldest days of the winter, but that NGPL's NSS tariffs had "fairly rigid rules," and the NSS tariffs required that Peoples Gas purchase 75 days of storage. *Id.* As a result, Peoples Gas had to "contract for and pay for a great deal more capacity than it really needed." *Id.* The NSS tariff also had stringent rules regarding inventory levels that the utility was required to maintain. *Id.* at 997-98. Like the excess capacity levels, the inventory level requirement was something that Peoples Gas did not need. *Id*.

To manage this excess capacity, Peoples Gas entered into a Storage Optimization Contract ("SOC") with EMW, *id.* at 996-99; Wear Cross Ex.14, under which EMW was obligated to "optimize" the excess capacity under the NSS tariffs. Apr. 20, 2005 Tr. at 998. Mr. Wear testified that the "NSS [storage optimization contract was] a gas charge contract . . . [and therefore] all costs and revenues associated with [the contract] would flow through the gas charge." *Id.* at 996; *see also* Staff Ex. 7.00 at 49, L. 1358-63.

Staff witnesses Rearden and Hathhorn and City-CUB witness Decker testified regarding Peoples Gas' SOC with EMW. Dr. Rearden testified that the SOC provided that Peoples Gas and EMW share revenues generated by EMW through its optimization of the excess capacity associated with PGL's NSS contracts. Staff Ex. 7.00 at 47, L. 1303-10. Peoples Gas had at least one other offer to optimize the NSS tariff excess capacity. *Id*. at 46, L. 1282-83. That offer, from TPC (which had previously optimized PGL's NSS excess storage capacity), had sharing provisions much more favorable to Peoples Gas and its ratepayers than the Peoples Gas-EMW SOC. *Id*. at 46-47, L. 1284-1310.

Dr. Rearden explained that Peoples Gas chose to accept EMW's patently inferior offer because EMW was sharing one half of its revenues with Peoples Energy. *Id*. at 48, L. 1330-31. Ms. Hathhorn affirmed Dr. Rearden's testimony, adding that Peoples[] [Gas'] parent, PEC, had oral sharing agreements with EMW during the reconciliation period." Staff Ex. 13.00 at 4, L. 76-77.

Ms. Hathhorn further testified that Peoples Gas provided inconsistent information as to how the revenue sharing of the SOC between Peoples Energy and EMW was accomplished. Staff Ex. 9.00 at 15, L. 361-62. Under one scenario, EMW transferred its profits to enovate, which then sent half of the profits to Peoples Energy. *Id*. at 15, L. 362-63, 368-69. Under the other scenario relayed by PGL, enovate received the SOC profits directly and then split them 50-50 with Peoples Energy. *Id*. at 15, L. 364-65, L. 370-71. Regardless of the method, the profits were shared, and the end result was that Peoples Gas chose to enter an inferior optimization arrangement so that its parent company could increase the parent's bottom line. This, of course, was done to the detriment of customers.

Staff recommends that Peoples Gas be ordered to refund $1,340,455 because of the SOC. *See*, Staff Ex. 9.00 at Schedules 9.02, 9.03. The proposed refund is made up of two sources: (1) money that was inappropriately shared with PERC (a Peoples Gas unregulated affiliate) and (2) revenues received by EMW and/or Enron under the SOC.

The first source totals $623,000 and consists of $120,000 in management fees that were transferred to PERC by EMW (or enovate) and $503,000 that PERC received as its one half share of the revenues that EMW (or enovate) generated by optimizing the NSS excess capacity. Staff Ex. 9.00 at Schedule 9.02.

The revenues received by EMW and/or Enron totaled $717,455. Dr. Rearden explained that the SOC revenues received by EMW and/or Enron should also be refunded to ratepayers for at least two reasons. First, Dr. Rearden pointed out that he does not understand why Peoples Gas did not optimize the NSS excess capacity itself. Dr. Rearden stated that Peoples Gas demonstrated an ability to negotiate and enter into sophisticated arrangements and that any superior ability EMW may have possessed in extracting value from the NSS contract was not worth the price Peoples Gas was required to pay under the SOC. Staff Ex. 7.00 at 49, L. 1343-49.

Second, Dr. Rearden stated that ratepayers bore the risk of the SOC. Because the costs of the SOC were passed through the PGA to ratepayers, PGA rules require that ratepayers enjoy any revenues generated under the contract. *Id*. at 49, L. 1356-64.

GCI agree with Staff witnesses Rearden's and Hathhorn's analysis of the Peoples Gas-EMW optimization contract. The Commission should order Peoples Gas to refund $1,340,455 associated with the SOC during the reconciliation period.

2. Peoples Gas' NSS and Storage Optimization Contracts Contained Strange Provisions That Exemplify the Intentionally Complex and Dubious Transactions Between Enron and Peoples Gas

Besides the imprudence of the Peoples Gas-EMW SOC, the utility's NSS contracts and the optimization contracts contained odd provisions that illustrate the complex and questionable transactions that Peoples Gas entered into with affiliates of Enron. The first oddity is the fact that Peoples Gas had two (2) NSS storage contracts during the reconciliation year. As noted above, Peoples Gas witness Wear testified that the utility needed only 10-20 days of no notice supply to meet peaking needs on the coldest winter days. Apr. 20, 2005 Tr. at 997; City-CUB Ex. 1.0 at 50, L. 1420-23. Mr. Wear's assessment was verified by Peoples Gas (and Peoples Energy CEO) Mr. Patrick, who testified during his deposition that Peoples Gas needed only about 15 days of peaking service. City-CUB Ex. 1.0 at 52, L. 1505-10; City-CUB Ex. 1.25. Yet, Mr. Wear confirmed that the two NSS contracts each provided 75 days of no-notice firm service. Apr. 20, 2005 Tr. at 997.

The SOC defined different categories of gas volumes. The "Maximum Storage Volume" was the total volume of gas that Peoples Gas was required to inject under the NSS tariffs. That volume for the two NSS contracts was 19,218,750 MMBtus. Apr. 20, 2005 Tr. at 1002-03; City-CUB Ex. 1.0 at 51, L. 1447-50; Wear Cross Ex. 14 at 4. That volume was split into two amounts – the "Initial Unrestricted Capacity" and the "Initial Restricted Capacity." Apr. 20, 2005 Tr. at 1003; City-CUB Ex. 1.0 at 50-51, L. 1443-50; Wear Cross Ex. 14 at 4-5. The Initial Unrestricted Capacity represented the volume of gas that Peoples Gas "did not need for meeting its customers' requirements." Apr. 20, 2005 Tr. at 1003. The total volume of Initial Unrestricted Capacity under the SOC was 16,618,750 MMBtus. City-CUB Ex. 1.0 at 51, L. 1447-50; Wear Cross Ex.

14 at 5. The volume PGL needed for ratepayers (Initial Restricted Capacity) was only 2,600,000 MMBtus. City-CUB Ex. 1.0 at 51, L. 1447-50; Wear Cross Ex. 14 at 5; Apr. 20, 2005 Tr. at 1003.

More than 86% (16,618,750/19,218,750) of the total volume under the two NSS contracts was gas that Peoples Gas "did not need for meeting its customers' requirements." Apr. 20, 2005 Tr. at 1003. The volume of gas that the utility did need for its customers, less than 14% of the Maximum Storage Volume, was far less than the amount of storage that Peoples Gas purchased under either of the two NSS contracts. (NSS Contract 1 had a Maximum Storage Volume of 9,943,725 MMBtus and NSS Contract 2 had a Maximum Storage Volume of 9,275,025 MMBtus). City-CUB Ex. 1.0 at 51, L. 1447-50; Wear Cross Ex. 14 at 4.

Given that Peoples Gas only needed 10-20 days of no notice service, one can fairly ask, "Why have two contracts that each provided 75 days of service?" In fact, Peoples Gas (and Peoples Energy CEO) Thomas Patrick may ask the same question. During his deposition, Mr. Patrick testified that he assumed that Peoples Gas had one NSS contract during the reconciliation period (City-CUB Ex. 1.0 at 52, L. 1489-1501; City-CUB Ex. 1.25), because Peoples Gas only needed one contract to get the "15 days or so" of the no notice service. City-CUB Ex. 1.0 at 52, L. 1507-08; City-CUB Ex. 1.25.

City-CUB witness Decker testified that while it makes sense for gas utilities to enter into an optimization agreement for excess storage capacity, utilities incur risks by purchasing more contract storage than is necessary. Ms. Decker testified that there are costs associated with such capacity and hedging, if, for example, the prices locked in through hedges exceed market prices. City-CUB Ex. 1.0 at 52, L. 1478-85. Ms. Decker posited a possible explanation as to why

Peoples Gas would choose to enter into the second NSS contract, for far more storage than it needed, despite those risks. Ms. Decker's explanation concerns the second odd feature of Peoples Gas' storage optimization agreement with EMW – the actual structure of the SOC.

Article IV.2 of the SOC obligated EMW to inject gas into Peoples Gas' NSS storage inventory. Wear Cross Ex. 14 at 5; Apr. 20, 2005 Tr. at 1006-07; City-CUB Ex. 1.0 at 51, L. 1470-71. Article V.1 of the SOC provided that when EMW caused gas to be injected into Peoples Gas' NSS storage inventory, title to the same amount of gas in the utility's Manlove storage field was transferred to EMW pursuant to Article XI.1 of the SOC. Wear Cross Ex. 14 at 5; Apr. 20, 2005 Tr. at 1007-08; City-CUB Ex. 1.0 at 51, L. 1471-74. When EMW injected the Initial Unrestricted Capacity(16,618,750 MMBtus) into Peoples Gas' NSS storage, Peoples Gas was required to transfer title to the same amount of gas in Manlove field to EMW.

Ms. Decker testified that by having a second NSS contract, a much greater volume of gas in Manlove field could be transferred to EMW. The amount of gas in Manlove made available to EMW was substantial, and it appears that it had fewer restrictions on its redeployment for midstream services. City-CUB Ex. 1.0 at 51, L. 1464-66. Mr. Wear testified that the portion of storage at its Manlove field that Peoples Gas made available to its customers was approximately 25.5 million MMBtus. Apr. 20, 2005 Tr. at 1004; Peoples Gas Ex. F at 56, L. 1259-61. This means that under the SOC Peoples Gas gave EMW more than 65% (16,618,750/25,500,000) of the volume of gas in Manlove field, which Peoples Gas stated was reserved for its customers, free of the restrictions attached to the NSS gas volumes. Ms. Decker added that this tactic was consistent with Peoples Energy's strategy of increasing its bottom line by increasing revenues from its midstream services. City-CUB Ex. 1.0 at 51, L. 1464-66; at 53, L. 1525-27.

While Ms. Decker stated that ratepayers were harmed because large volumes of gas in Manlove field were transferred to EMW, she was not able to quantify that harm. Ms. Decker explained that Peoples Gas had failed to produce data – such as "the pricing (on both the buys and sells), quantity transferred, and the timing of transactions" – that would have allowed her to offer an estimate of the harm. City-CUB Ex. 1.0 at 53-54, L. 1536-43.

F. Staff's Proposed Adjustments Regarding Individual Deals

1. The Commission Should Adopt Staff"s Proposed Refinery Fuel Gas Adjustment.

Prior to the reconciliation year, Peoples Gas purchased a category of gas known as refinery fuel gas ("RFG") from a company affiliated with Citgo Petroleum. Staff Ex. 9.00 at 11, L. 281-83. Under that arrangement, which was in effect for the utility's prior reconciliation period, Peoples Gas purchased RFG directly from the Citgo affiliate at [redacted] of FOM. Staff Ex. 9.00 at Attach. B. Beginning in FY 2001, Peoples Gas still purchased RFG, but at a higher price than it had paid during the previous reconciliation period. Staff Ex. 9.00 at 12, L. 293-94. However, the utility no longer purchased RFG directly from the Citgo affiliate.

During the reconciliation period, PGL did not renew its direct purchase arrangement with Citgo. Instead, PERC, pursuant to an unwritten agreement, purchased the RFG from the refinery at [redacted] of the first of the month price (FOM) – the same discount that PGL had previously enjoyed. Staff Ex. 9.00 at Attach. B. PERC then sold the RFG to Enron Midwest at [redacted] of the average city gate price. *Id.* Finally, Peoples Gas bought the RFG from Enron Midwest at [redacted] of the FOM – that is, at yet another markup from the price PERC paid Citgo. *Id.* Consistent with Ms. Hathhorn's unrebutted testimony, EMW's 2.5% FOM profit was then transferred to enovate

to be split between PEC and Enron. Staff Ex. 9.0 at 9, L. 211-12; at 14, L. 334-35. In addition, PERC realized a 17.5% FOM profit in the RFG sale to Enron Midwest. *Id.* at Attach B. Tellingly, the [redacted] FOM price at which EMW sold RFG to Peoples Gas for "System Supply" – that is, for ratepayers – is markedly higher than the [redacted] FOM price at which EMW sold RFG to Peoples Gas for "Company Use." *Id.*

This deal is imprudent on three levels. First, by inserting PERC into Peoples Gas' position as the direct buyer from the Citgo affiliate, Peoples Gas paid 20 percentage points more for RFG in the reconciliation year than it did during the prior year. Staff witness Hathhorn added that Peoples Gas failed to justify this change in procurement procedures that increased costs to customers. *Id.* at L. 319-22.

Incredibly, Peoples Gas witness Wear defended the new RFG transaction structure, stating that "[a]ny disallowance whatsoever is penalizing Peoples Gas for buying discounted gas for its customers." PGL Ex. L at 47, L. 1045- 46. Apparently, in Peoples Gas' view of the world, it should be lauded for purchasing RFG below market prices, even though the new deal structure enabled the utility's unregulated affiliate to siphon off profits from the deal at the expense of ratepayers. Ms. Hathhorn correctly described this argument as "disingenuous." Staff Ex. 13.00 at 3, L. 58-60. Ms. Hathhorn explained that her recommended disallowance is warranted because Peoples Gas chose to allow PERC to assume the Citgo RFG contract. *Id*. By diverting that economic opportunity, Peoples Gas required its ratepayers to pay PERC a premium for its RFG purchases. *Id.* at L. 58- 62.

Second, the RFG deal was apparently designed to avoid Section 7- 101's prohibition against affiliate transactions. Section 7- 101(3) requires that utilities obtain Commission

approval before engaging in transactions with affiliates. 220 ILCS 5/7- 101(3). By inserting EMW between PERC and Peoples Gas, the utility effectively "laundered" the transaction to avoid the Commission scrutiny required by Section 7- 101.

Third, the RFG deal was imprudent because Peoples Gas accepted EMW's marked up price of gas, after having foregone an opportunity to pursue a direct purchase at a lower price.

Because EMW's profits were split 50/50 between Peoples Energy and Enron North America, (*Id.* at 8-9, L. 198-219), Peoples Energy likely received a piece of the RFG profit pie. Ms. Hatthorn testified that Peoples gas failed to provide documentation "to determine whether [Peoples Energy] received half [of EMW's] markup." *Id.* at 14, L. 331- 33. Based on documents she did receive, Ms. Hathhorn recommended that Peoples Gas be required to refund the approximately $2.2 million more it paid for RFG under the new procurement arrangement than it would have had the utility continued to purchase RFG as it had done in the past. Staff Ex. 9.00 at 13, L. 321- 23, Schedule 9.01. Ms. Hathhorn's analysis and proposed RFG adjustment should be adopted by the Commission.

2. The Commission Should Adopt Staff's Proposed Trunkline Deal Adjustment.

Like the RFG deal, the Trunkline deal was a transaction between Peoples Gas and an affiliate (enovate) with EMW inserted between the two as a means to avoid the Act's prohibition against affiliate transactions and the Commission's scrutiny. Staff witness Dr. Rearden described the three steps involved in this transaction. In the first step, enovate leased Trunkline capacity and obtained base load gas supplies from PERC and Reliant to fill the leased capacity. Staff Ex. 7.00 at 50, L. 1377-80; Staff Ex. 9.00 at 18, L. 436-38. Next, enovate sold a firm daily gas call

to EMW with delivery at the Chicago citygate. Staff Ex. 7.00 at 50, L. 1383-84; Staff Ex. 9.00 at 18, L. 438. Finally, EMW sold a firm daily gas call to Peoples Gas with delivery at the Chicago citygate. Staff Ex. 7.00 at 50, L. 1389-90; Staff Ex. 9.00 at 19, L. 439-40. EMW sold the service to Peoples Gas at the same price at which it was purchased from enovate. Staff Ex. 7.00 at 50, L. 1390-91; Staff Ex. 9.00 at 19, L. 440-41.

Staff witnesses Hathhorn and Rearden explained that this series of transactions is problematic because they were not done at arms-length. Staff Ex. 7.00 at 51, L. 1394-95; Staff Ex. 9.00 at 19, L. 439-447; Staff Ex. 12.00 at 38, L. 839-43; Staff Ex. 13.00 at 19, L. 93-99. EMW had no real role in this series of transactions other than to serve as a buffer between enovate and Peoples Gas, two affiliated entities. Staff Ex. 9.00 at 19, L. 439-447; Staff Ex. 12.00 at 38, L. 839-43; Staff Ex. 13.00 at 19, L. 93-99.

This fact is demonstrated by Attachment F to Ms. Hathhorn's Additional Direct/Rebuttal Testimony. Attachment F is an e-mail from Maria DiVito to Richard E. Dobson and Timothy Hermann. (Linda M. Callas is copied on the e-mail.) Staff Ex. 9.00 at Attach. F. The e-mail states that attached to the e-mail is a spreadsheet showing the revenue stream for the Trunkline deal. *Id*. The attached spreadsheet shows four columns: (1) "PGL paying enovate"; (2) "enovate paying Trunkline"; (3) "Net" ("Net" is the difference between the first two entries); and (4) PERC's 50% (the figures in this column are 50% of the figures in the "Net" column). *Id*. EMW is mentioned nowhere in this document.

The document also shows that PERC (one of Peoples Gas' unregulated affiliates) received 50% of the profits under the Trunkline deal. Staff Ex. 9.00 at Attach. F; *see also, e.g.,* Staff Ex. 13.00 at 5, L. 99-101. Because this was not an arms-length transaction and because the deal was

designed to conceal an unapproved affiliate transaction, both Dr. Rearden and Ms. Hathhorn recommended that the revenues "earned" by PERC (and/or Peoples Energy) be returned to ratepayers. Staff Ex. 7.00 at 52, L. 1424-27; Staff Ex. 9.00 at 16, L. 390-93. Ms. Hathhorn calculated that amount to be $372,088. Staff Ex. 9.00 at Sched. 9.04. The Commission should adopt Staff's position and recommended refund.

G. The Commission Should Disallow Peoples Gas' Imprudent FY 2001 Gas Lost and Unaccounted For (GLU) Costs.

During the 2001 reconciliation period, PGL experienced a dramatic increase in lost and unaccounted-for gas ("GLU"). As a result, PGL's gas charges increased dramatically. Despite recognizing this radical increase in GLU, PGL took no steps to correct the problem until at least two years after the increase had begun. The management lapses that permitted the problem to grow to such size and the later lack of corrective action were imprudent, and they harmed ratepayers in the reconciliation period. The Commission should disallow $38 million in costs incurred because of Peoples Gas' spike in GLU during the reconciliation period.

The evidence of record demonstrates a striking increase in PGL's GLU during the reconciliation period and continuing into FY 2002 and FY 2003. City-CUB Ex. 1.0 at 28-29, L. 809-11. GLU typically includes gas from leakage, meter inaccuracies, pressure or other variants and billing lag. It is clear, however, that Peoples Gas' extraordinary increase in GLU during the reconciliation period is not attributable to commonly encountered causes. As City-CUB witness Lindy Decker testified, if the cause were a true billing or metering timing lag, the volumes would "come back" in the next period. That is, if the GLU was 3 Bcf short in a period due to the timing

of metering or a billing lag, then the subsequent period would be 3 Bcf long. This was not the case for Peoples Gas. *Id.* at 28-29, L. 803-11.

In the two years preceding the reconciliation period, Peoples Gas' GLU hovered around 1%, but inexplicably skyrocketed to 3.76% in 2001. Zack Cross Ex. 4, Zack Cross Ex. 5. This number represents an increase in PGL's GLU of *nearly 400 percent*. City-CUB Ex. 2.0 at 25, L.612-13. The aberrant nature of GLU during the reconciliation period is underscored by the testimony of PGL witness Thomas Zack confirming Peoples Gas' GLU percentages in the years preceding FY 2001: 1.10% (1998), 1.09% (1999), and 0.84% (2000). Apr. 18, 2005 Tr. at 714. Thus, during the reconciliation period PGL ratepayers paid for a significantly larger quantity of gas than was actually delivered during the reconciliation period. City-CUB Ex. 2.0 at 25, L. 610-12. Moreover, Peoples Gas' GLU did not return to pre-FY 2001 levels in 2002 or 2003; in those years, the utility's GLU was 2.89% and 3.83%, respectively. Apr. 18, 2005 Tr. at 714-15.

Peoples Gas has attempted to rebut the evidence of the sharp, unremedied rise in GLU by presenting comparative data purportedly demonstrating that its GLU levels were reasonable. The data and the comparison have fundamental flaws. Peoples Gas has compared its GLU levels to the various GLU levels that appear in ICC Form 21 data collected for Illinois gas utilities. PGL Ex. K at 6, L. 106-24. The question before the Commission, however, is not whether Peoples Gas' GLU fell within the range of results experienced by any Illinois utility. The question is whether the utility's GLU was reasonable and prudent, for that utility, in the circumstances that existed at the time. PGL's comparison does not answer the more pertinent question, only whether Peoples Gas' GLU fell within the range of GLU figures reported by Illinois gas utilities.

As Ms. Decker testified, most of the other gas utilities operating in Illinois are not

comparable in terms of the relationship of total volumes of gas send-out and numbers of customers, and any comparison to those utilities has no bearing on whether Peoples Gas' GLU costs were prudent. City-CUB Ex. 2.0 at 29-30, L. 709-15. Moreover, Mr. Zack's testimony uses a five-year average to make Peoples Gas' GLU seem comparable to a single year GLU performance benchmark. PGL Ex. K at 7, L. 143-44. Mr. Zack's preference for multiple year averages ignores the fact that this reconciliation is for a single year. City-CUB Ex. 2.0 at 30, n.2.

Although Peoples Gas quibbled with Ms. Decker's computation of the GLU amount, (PGL Ex. K at 4-5, L. 69-91), using the figures Peoples Gas prefers simply confirms that there was an extraordinary increase in GLU during the reconciliation period. Remember, according to PGL, the utility experienced a GLU level of 0.84% in 2000. The GLU level in 2001 increased by almost 400%, to 3.76%. The increase was unreasonable and not consistent with prudent gas operations. The rise in GLU is unexplained and unremedied. City-CUB Ex. 2.0 at 33-34, L. 798-807.

The evidence further establishes that Peoples Gas' management recognized the GLU problem. Indeed, e-mails between PGL executives evince their alarm about the increasing GLU. Zack Cross Ex. 1, Zack Cross Ex. 2. In an e-mail dated March 28, 2001, to Kathy Donofrio, Vice President of Marketing, Rates and Business Development, PGL employee Sam Fiorella wrote, "The [GLU] amount has skyrocketed from (11.3) million to 46.4 million therms, cal. Yr. 1999 to 2000." Zack Cross Ex. 1. In the same chain of e-mails, Ms. Donofrio states: "Talked to Charlie re: Peoples Gas's large amount of unaccounted for gas . . . I'm still concerned that a large unacc[ounted] for might lead one to think that it's the symptom of accounting/control problems."

Id. Conspicuously absent from the record is any indication that upon discovering the problem, PGL attempted any corrective action for the "runaway" GLU Peoples Gas and its captive customers experienced beginning in the reconciliation period.

In fact, the only document discussing remedial action for the 2000-2001 GLU increase is a 2003 document labeled the "Gas Lost Work Plan." Zack Cross Ex. 3. In that document, PGL's Gas Supply group listed possible causes of the extraordinary GLU increase, including "Enron assumption of transportation and deliver of bundled citygate supplies beginning October 1999," and "Increase in Hub transactions and management of Hub by beginning of early calendar 2000." *Id.* There is no evidence, however, that Peoples Gas took any action to remedy the unexplained spike in GLU, particularly in the reconciliation period.

The undisputed evidence establishes a dramatic increase in GLU during the reconciliation period. Despite Peoples Gas' awareness of its skyrocketing GLU, the utility has offered no evidence of any action it took to correct the problem. As a result of Peoples Gas' imprudent management of GLU, ratepayers paid significantly higher PGA costs. Accordingly, the Commission must disallow the $38,102,680 in excess costs PGL recovered from ratepayers. City-CUB Ex. 2.0 at 34, L. 810-24.

H. Peoples Gas' FY 2001 Price Risk Management (Hedging) Practices Were Not Reasonable Or Prudent

Hedging is a price risk management technique for addressing the risks of price change, not price level. City Ex. 1.0 at 13, L. 316; at 17, L. 413-16; PGL Ex. H at 9, L. 239-40; Apr. 21, 2005 Tr. at 1207. Price volatility is a quantitative measure of the likelihood of price changes of a

certain magnitude over a certain period of time. City Ex. 1.0 at 19, L. 462-63. Price volatility shows itself to consumers as price risk exposure, the combined effect on customer bills of price volatility, price level, and consumption. Apr. 21, 2005 Tr. at 1208. These risks can be hedged using futures contracts or financial derivatives. A futures contract allows a utility to fix the price of a specific quantity of natural gas delivered at a future time. By using more flexible financial hedges and matching an expected physical (sale or purchase) contract with a complementary paper (purchase or sale, respectively) contract for the same commodity quantity at a known price, one can often fix the ultimate price for that purchase or sale. City Ex. 1.0 at 11, L. 267-71.

The Commission's Order Commencing PGA Reconciliation Proceedings expressly required Peoples Gas to address the prudence of its hedging activities to provide price risk management with respect to PGA charge gas costs.

> Each utility shall also demonstrate that its gas supplies purchased during the reconciliation period were prudently purchased. In addition, the company shall describe the measures, if any, taken by the utility during the reconciliation year to insulate the PGA from price volatility in the wholesale natural gas market explaining any hedging strategies utilized, the extent to which the strategies were actually implemented, and the actual impact on the PGA of implementing the strategies.

Order at 2.

High volatility combined with high prices and the high demands of winter heating yields a potential (risk) for extraordinary bills (price x volume). City Ex. 1.0 at 33, L. 822-25; City Ex. 2.0 at 22, L. 424-29; Apr. 21, 2005 Tr. at 1208. These were the risks faced by Peoples Gas' ratepayers in the period leading to and during FY 2001. These are the risks Peoples Gas decided not to manage. Apr. 21, 2005 Tr. at 1166; City Ex. 1.0 at 7, L. 158-60.

1. Only the Rigorous Quantitative Assessments of Hedging Issues in City and CUB Testimony Deserve Full Weight In the Commission's Deliberations

The City and CUB presented the testimony of two experts on hedging issues -- former EIA gas price expert John Herbert for the City and consumer energy expert Brian Ross for CUB. Brian Ross is an experienced energy consultant who has direct experience with Illinois reconciliation proceedings and with Peoples Gas. CUB Ex. 1.0 at 1. John Herbert has over 20 years of public and private sector experience dealing with natural gas prices, industry trends, and other market issues. City Ex. 1.0 at 1-3, L. 7-73.

In contrast, Peoples Gas presented only the testimony of company executives who claim no special expertise in price risk management. Peoples Gas' testimony on hedging issues, like the utility's reconciliation period price risk management, was a cursory, non-quantitative effort that relied on positions pertinent to different circumstances. The utility's principal witnesses on this issue were Mr. Frank Graves and Mr. David Wear. *See* PGL Ex. B, C, F, L, O; PGL Ex. H, E, R. Mr. Graves' testimony was almost entirely subjective and relies heavily on acceptance of *post hoc* rationalization. Mr. Wear's testimony, for reasons explained earlier in Section C.3 of this brief, lacks credibility and does not merit significant weight in the Commission's deliberations. Neither witness supported his testimony with pertinent objective analysis.

Staff presented only Dr. David Rearden's brief, incidental remarks, unaccompanied by supporting analysis.

2. Peoples Gas Was Imprudent in Failing to Establish An Effective Risk Management Plan for the Reconciliation Period

Gas supplies are Peoples Gas' single most important commodity purchase. City Ex. 1.0

at 35, L. 887. Prudence requires that utilities like Peoples Gas have and follow a well-defined price risk management program. CUB Ex. 1.0 at 11-12, L. 885-88. According to Mr. Herbert, such a program must be a "coherent, coordinated collection of practices, principles and criteria that guide the utility's actions to manage the price risks," and it should "ensure that a portion of its regulated customers' requirements for gas [usually a minimum assured level of demand] is not exposed to price risk." City Ex. 1.0 at 35, L. 885-87; at 36, L. 907-09. When the price risk is significant, as it was in the purchasing period for FY 2001 supplies, "it is imprudent for a utility not to hedge requirements that will necessarily be acquired." *Id.* at 36, L. 916-17.

Whether by dereliction or by design, Peoples Gas did not have a functioning price risk management plan in place for the period of greatest price risk exposure in FY 2001. *Id.* at 41, 48-55. During a colder than normal winter heating season and a period of high price volatility and unprecedented price levels, Peoples Gas ratepayers were left totally exposed to the vagaries of an observably volatile fuel market, while Peoples Gas itself was not at risk. *Id.* at 30, L. 767-86; CUB Ex. 1.0 at 14, L. 1103-05.

According to the utility, Peoples Gas followed two distinct price protection plans during the reconciliation period. Apr. 20, 2005 Tr. at 962. The first was Peoples Gas' 1998 Gas Supply Price Protection Strategy ("1998 Plan"), which the utility adopted in August 1998. PGL Ex. G at 13-14, L. 280-85. The second was another Gas Supply Price Protection Strategy, which was adopted in April 2001. Wear Cross Ex. 8.

The 1998 Plan was an element of Peoples Gas' failed effort to offer a fixed price service. The Plan had several features that made it unreasonable and imprudent as a price risk management plan for ratepayers in FY 2001. As a supporting component of Peoples Gas'

strategy to implement a flat rate service offering, the plan was focused more on benefits for the utility than protection against market price risks for captive consumers. City Ex. 2.0 at 6, L. 106-07. Every expert in this case, including Peoples Gas' independent expert, agrees that prudent hedging is designed to protect against price volatility, and not price level. City Ex. 1.0 at 17, L. 434-42; CUB Ex. 1.0 at 6; Apr. 20, 2005 Tr. at 962; PGL Ex. H at 9, L. 239-40. Yet Peoples Gas' 1998 Plan defined its hedging triggers in terms of price level, not price volatility. Apr. 20, 2005 Tr. at 969; City Ex. 2.0 at 7, L. l31-32; PGL Ex. G at 13, L. 280-81. The 1998 Plan's original triggers mandated hedging when the market price fell to a particular level, (PGL Ex. G at 13-14, L. 280-84; Apr. 20, 2005 Tr. at 969) -- one that would guarantee a profit on service offered at Peoples Gas' proposed flat rate. City Ex. 2.0 at 4, L. 65-69.

When Peoples Gas' flat rate proposal was not implemented, the hedging plan -- suddenly a leftover -- was never updated to reflect either the needs of ratepayers or changing market conditions. City Ex. 1.0 at 26, L.657-60. Peoples Gas apparently recognized this failing. In 1999, Peoples Gas developed a replacement plan called the "Gas Supply Protection Strategy."

> Unlike its August 1998 predecessor, the 1999 strategy was "designed to mitigate price volatility *for our customers* during the summer and winter months therefore providing the ratepayers with stable and reasonable prices over time." (Emphasis added). In other words, the document outlines a hedging strategy generally consistent with the requirements I defined in my Direct Testimony for a prudent hedging strategy.

City Ex. 2.0 at 8, L. 141-45. Despite its awareness of the inadequacies of its 1998 plan, Peoples Gas never implemented the 1999 Plan. As Mr. Herbert observed, "even though a strategy to protect customers was prepared and at hand, . . . the strategy was never implemented." City Ex. 2.0 at 8, L. 145-47.

Consequently, during the reconciliation period, the hedging plan in effect for Peoples Gas' ratepayers was the 1998 Plan, which still was not tuned to price volatility and was not designed to reduce consumers' price risk exposure. More important, since it was never updated, it did not define triggers for FY 2001. Wear Cross Ex. 8. Under that plan, no amount of price volatility and no price level could have triggered protective hedging in FY 2001 for Peoples Gas' captive customers. In fact, no hedging was initiated under that plan for the reconciliation period (Apr. 20, 2005 Tr. at 969), since the 1998 plan was, in reality and in effect, inoperative for FY 2001. The essentially inoperative program was controlling until after the FY 2001 heating season.

> After rejecting the Commission's modifications to the [utility's] proposal in Docket 98-0820, Peoples Gas did not change its 1998 Price Protection Strategy to reflect this new reality, or its obligation to follow prudent procurement practices. Instead, that plan – with hedging guidelines that expired in March 1999 -- was not replaced until April 19, 2001. That is, from March 1999 through April 19, 2001, Peoples Gas may have had a plan nominally in place, but that plan was clearly not focused on the price risk exposure of regulated customers.

City Ex. 2.0 at 46, L. 898-904.

The second price risk management plan in effect during FY 2001 was a Gas Supply Price Protection Strategy adopted in May 2001. PGL Ex. B at 7, L. 140-42. However, the plan, which resembled the unadopted 1999 Plan, did not become effective until after the winter heating season of the reconciliation period. CUB Ex. 3.0 at 22, L. 492-99. The predictable result was that the utility's ratepayers received no protection when they needed it most, and when prudence most required that Peoples Gas hedge the risks its customers faced.

3. Peoples Gas Was Imprudent In Refusing to Protect Its Ratepayers Against Volatile Prices That Called for Meaningful Price Risk Management (Hedging)

The City and CUB presented evidence on the gas market environment in the months leading up to and during the reconciliation period. City Ex. 1.0 at 6, L. 144-51; CUB Ex. 1.0 at 9-10. On the basis of that evidence, those experts concluded that Peoples Gas was imprudent in failing to put in place, and to use, a reasonable, effective plan to manage gas price risk on behalf of its captive utility customers. City Ex. 1.0 at 41, L. 1048-55; CUB Ex. 1.0 at 15.

The hedging experts in the case agree that the role of hedging is to fix or limit a commodity's price movement. City Ex. 1.0 at 17, L. 434-50; CUB Ex. 1.0 at 6; Apr. 20, 2005 Tr. at 962; Apr. 21, 2005 Tr. at 1309. Although price levels are difficult to predict and a poor basis for price risk management, price volatility can be quantified and managed. City Ex. 1.0 at 20, L. 487-90; CUB Ex. 1.0 at 4. It is undisputed that Peoples Gas had the knowledge and the ability to hedge the price risk exposure associated with FY 2001 gas supplies. *See, e.g.,* City Ex. 1.0 at 24-26, L. 600-50. Peoples Gas declined every available option -- from fixed price contracts for future delivery to standardized paper contracts and financial derivatives. CUB Ex. 1.0 at 5, 12.

In his assessment of the circumstances in which Peoples Gas made its decision not to hedge gas prices for the reconciliation period, Mr Herbert "took account of: (a) the Company's risk management knowledge and capabilities (and the risk management knowledge and capabilities of Peoples Energy); (b) the price volatility information that was available at the time Peoples was preparing for, and during, the 2000-2001 heating season; and ©) the information that was considered, or reasonably should have been considered, by Peoples -- all at the time the

utility was making its FY01 gas purchase and price risk management decisions." City Ex. 1.0 at 4, L. 95-102. He paid particular attention to the disparity between its corporate capabilities in this area and its action on behalf of its ratepayers. City Ex. 1.0 at 5, L. 107-09. Similarly, Mr. Ross examined the circumstances prevailing in the relevant time periods, Peoples Gas' available options, and its technical capabilities. He reviewed Peoples Gas' prior experience with volatile prices and managing such risks, the techniques the utility had available to hedge price risk, and the effect of Peoples Gas' utility's decision to rely on market indexed purchases for the bulk of its gas supply. CUB Ex. 1.0 at 7-10.

Their findings about the pertinent circumstances -- many presented in terms of objective, quantitative data -- were compelling with respect to the need for effective management of ratepayers' heightened price risk exposure for the reconciliation period. They found that:

> • Because almost 95% of the gas charges Peoples Gas collected are attributable to commodity cost, bills were almost as volatile as gas prices (City Ex. 1.0 at 22, L. 556-60);
>
> • There was an easily observable 13% rise in gas price volatility over the previous year (City Ex. 1.0 at 31, L. 785-86);
>
> • The number of times changes in day-to-day gas prices exceeded 10% was quite large in the period leading up to FY 2001 (*Id.* at 30, L. 761-62 and City Ex. 1.2);
>
> • In early 2000, prices began to rise, gas supplies remained tight, and production increases appeared very inelastic (City Ex. 1.0 at 30, L. 748-49);
>
> • Heading into the 2000/2001 heating season, storage levels were very low *(Id.* at 755-56); and
>
> • Increased volatility and higher prices had elevated captive ratepayers' price risk exposure (because the same percentage change at a higher price levels has a greater effect on bills). City Ex. 1.0 at 33, L. 822-24.

The low storage quantities and persistent tight supplies pointed to a significant change in market dynamics. The readily observable data on market conditions required action. But, Peoples Gas left its ratepayers fully exposed to the market risks.

Other businesses reacted to these gas market conditions by hedging the heightened price risk. Among the business decisions makers who chose to hedge gas prices for the 2000-2001 winter were managers of the utility's unregulated affiliates, whom Peoples Gas presumably regards as reasonable and prudent business people. City Ex. 1.0 at 26, L. 645-57; CUB Ex. 3.0 at 13. "Retail customers must rely on their [utility] to closely monitor gas price risk exposure and price volatility and to take actions to protect them from potentially devastating price spikes." City Ex. 1.0 at 24, L. 591-94. The reasonable actions of other businesses in the same market are an essential element of the standard by which the Commission judges prudence – "that standard of care which a reasonable person would be expected to exercise under the circumstances encountered by utility management at the time decisions had to be made." *Ill. Commerce Comm'n v. Commonwealth Edison Co.,* Dkt. 84-0395, at 17 (Oct. 7, 1987).

Peoples Gas' expert, Mr. Graves, testified that the actions of unregulated firms should not be considered in assessing the prudence of the utility's decisions and actions. PGL Ex. H at 6, L. 135-42. Mr. Herbert disagreed:

> Mr. Graves' suggestion [that the Commission ignore the decisions of unregulated firms] would completely nullify the regulatory objective of anchoring the standard of prudence for regulated enterprises operating as monopolies in the reasonable decision-making behavior of ordinary businesses, which operate in competitive environments. Mr. Graves' reasoning would leave regulators without any comparative except other regulated entities, which may have the same lack of incentive associated

with cost pass-throughs to captive monopoly customers.

City Ex. 2.0 at 22, L. 443-49. As Mr. Ross testified, "The Company routinely incorporates management of price risk when it is exposed to price risk, but has decided to disregard price risk when it can pass this risk on to consumers." CUB Ex. 1.0 at 10. Peoples Gas' less diligent management of the same gas price risk on behalf of ratepayers was unreasonable and imprudent.

4. Contrary to Peoples Gas' Claim, the Utility's Storage Facilities Did Not Provide a Price Hedge for Its Captive Ratepayers

Peoples Gas has claimed that its storage has provided a price hedge for ratepayers and that its use of gas storage facilities saved ratepayers more than $130 million during the reconciliation period. PGL Ex. G at 13, L. 274-76. Both claims are false. In fact, Mr. Herbert found that under the utility's procurement and storage practices in FY 2001, ratepayers paid about $10 million more than they would have paid if Peoples Gas had simply purchased gas as needed on the spot market. City Ex. 1.0 at 46, L. 1134-77; City Ex. 2.0 at 36, L. 717-20.

As Mr. Herbert explained, effective hedging requires a match of purchases and hedged volumes. City Ex. 1.0 at 11, L. 267-71. Only then will prices for the hedged volume of the commodity be fixed or limited. However, Peoples Gas does not set aside any of its stored gas for its ratepayers. City Ex. 2.0 at 28, L. 548-52. Peoples Gas operates its storage facilities without active consideration of the ownership of stored gas volumes, making fixed or capped prices impossible.

Moreover, Peoples Gas' pricing mechanism for gas withdrawn from storage precludes any hedging potential that its storage facilities might otherwise offer. Peoples Gas does not set

the price ratepayers will pay for gas it injects into storage until the gas is withdrawn for delivery to ratepayers. At that time, Peoples Gas uses a LIFO-base pricing mechanism that incorporates year-to-date actual costs and estimated prices for purchases through the remainder of the year. PGL Ex. J at 3, L. 43-49. Consequently, prices for customers are never fixed in advance. The cost of Peoples Gas' stored gas recovered through gas charges is a complicated floating cost. City Ex. 1.0 at 45, L. 1147-51.

The simplest explanation of why Peoples Gas' LIFO-based pricing of stored gas completely nullified any potential hedging effect from its storage was provided by the utility's own independent expert, Frank Graves. His testimony confirmed Mr. Herbert's conclusion that Peoples Gas storage in fact provided no hedging protection for ratepayers during FY 2001.

> [O]nly if the company had made purchases in, say, October to inject into storage in the reconciliation year would the cost of those have effected [sic] the average cost of gas that was deemed to be withdrawn in the reconciliation year because they calculate the cost of storage withdrawals relative to the average cost of purchases throughout the entire reconciliation period.

Apr. 21, 2005 Tr. at 1167. Any potential price benefits of stored gas purchased at a low price in the preceding injection season are excluded from the calculation, which uses actual and estimated reconciliation period purchase costs, starting over on October 1 of each year. PGL Ex. J at 3, L. 43-49. Accordingly, there was no hedging effect and customers received no benefit from purchases injected into storage during the injection season for FY 2001.

Mr. Wear purported to calculate a $130 million customer benefit in FY 2001 for Peoples Gas' so-called hedging. PGL Ex. F at 58, L. 1296-98. It was nothing of the sort. First, the calculation is completely divorced from the prices customers pay. City Ex. 2.0 at 30, L. 761-68.

Second, it simply netted monthly injection and withdrawal volumes and costs using the utility's average monthly purchase costs and monthly average market prices, respectively. *Id.* at 38, L. 755-60; Apr. 20, 2005 Tr. at 986-87. Peoples Gas falsely labeled this summation of monthly imbalance costs a storage hedging benefit for customers.

5. Peoples Gas' Attempt To Blame the Commission for Its Refusal to Hedge Is Not Credible, And It Relies On An Extreme Interpretation of Prudence

Peoples Gas' attempt to blame the Commission for its refusal to hedge FY 2001 gas purchases simply is not credible. The record evidence clearly reveals that Peoples Gas' claimed fear of hedging without express Commission guidance is a thin, *post hoc* rationalization. The claim is contradicted by the record evidence, including accounts of the utility's own prior, unilateral, hedging activity. In any case, the Commission's position on the recovery of hedging costs -- about which the utility claims uncertainty -- was clear from its decisions on the hedging costs of Illinois utilities, including Peoples Gas. Only under Mr. Graves' extreme interpretation of prudence would Peoples Gas' amalgam of "things it might have done" be evaluated in place of what the utility actually did.

The evidence is indisputable that Peoples Gas had previously hedged gas purchases under circumstances practically identical to those it now argues made hedging too risky to pursue in FY 2001. City Ex. 2.0 at 15-16, L. 293-312; Apr. 19, 2005 Tr. at 729; Apr. 21, 2005 Tr. at 973.

> • Peoples Gas admitted that before FY 2001 it had worked with its suppliers to hedge a portion of its minimum winter supply needs through the use of financial instruments -- the type of hedging action Mr. Herbert and Mr. Ross testified that prudence requires. Wear Cross Ex. 8.
>
> • Peoples Gas admitted that it did not seek Commission approval to

initiate that hedging program. City Ex. 2.0 at 15-16, L. 296-98.

• Peoples Gas confirmed that the Commission had not required or encouraged the use of financial instruments it adopted. *Id.* at 16, L. 298-300.

• Peoples Gas admitted that it did not consider it imprudent to hedge without the guidance Mr. Graves now demands because – then, as in FY 2001 – the results of any program would be subject to review as part of the annual gas charge reconciliation process. *Id.* at L. 302-06.

• Peoples Gas admitted that it is now, and was in FY 2001, unaware of any disallowance related to hedged gas supply arrangements. *Id.* at L. 306-07.

Although Peoples Gas tries to distance itself from the hedging protections it implemented by emphasizing the role of its suppliers, the program approved by Peoples' Gas Trading Risk Management Committee specifically required that Peoples Gas "work[] with its suppliers to temper price volatility." Wear Cross Ex. 8 at 1. Moreover, Peoples Gas also has acknowledged that its Gas Purchase and Agency Agreement with Enron contains negotiated terms that facilitate just such hedging activity. City Ex. 2.0; Apr. 20, 2005 Tr. at 977.

Peoples Gas' pre-FY 2001 behavior and understanding of its obligations affirm the City's and CUB's position in this case. A utility's obligation to act prudently in providing regulated services to its customers does not depend on pre-approval or micro-management directives from the Commission. It is the Company's job to manage utility operations as the law requires, not the Commission's. Before the attempts of utility witness Frank Graves to justify Peoples Gas' lack of action in FY 2001, Peoples Gas did not consider hedging either imprudent or unauthorized. City Ex. 2.0 at 15-16, L. 293-312. Peoples Gas and other Illinois utilities treated hedging like any other utility operations issue -- a utility responsibility that is subject to review by regulators.

A large portion of Mr. Graves' testimony is devoted to the claim that Peoples Gas should

be excused from having to hedge a portion of their gas supplies for the 2000-01 winter because the Commission, in past orders, had not specifically "required" or "encouraged" such protection against price volatility for customers. PGL Ex. H at 13, L. 344-45, at 15, L. 427-28. In effect, Mr. Graves argues that utilities are absolved from the obligation to act prudently to protect customers from price risks unless the utility's own risk of disallowances has been removed by specific Commission order or encouragement. The Commission's consistent historical policy rejects Mr. Graves' proposed exemption. The Commission recently affirmed that policy in a passage quoted (but apparently ignored) by Mr. Graves:

> ***It is no more wise to create rules for hedging than it is to create rules for . . .*** the degree to which the company can rely upon firm transportation versus interruptible transportation services in swing months, . . . or ***any number of other details related to the prudent management of a utility's business. The Commission sets rates*** to prevent monopolies from taking advantage of market power, ***the Commission does not manage utility companies."***

PGL Ex. H at 14-15, L. 405-16 *citing* NOI Mgr Rpt in Dkt. 01-NOI-1 (Apr 17, 2001) (emphasis added). Mr. Graves' contrary suggestion would be the antithesis of a ***utility's*** traditional ***obligation to manage its business prudently***, without the burden or the crutch of regulatory micro-management. Adopting Mr. Graves policy would constitute a monumental change in Commission policy that is unwise and unjustified by the evidence of record.

On the basis of their evaluations of Peoples Gas' actions and the contemporaneous conditions, Mr. Ross and Mr. Herbert each concluded that Peoples Gas failed to act prudently. Mr. Ross found that "The Company failed, in managing its gas supply portfolio, to exercise a standard of care that a reasonable person would be expected to use in the light of known conditions and risks before and during the reconciliation year." CUB Ex. 1.0 at 2. Mr Herbert's

conclusions were similar.

> Peoples failed to make price risk management decisions and to take actions as indicated by contemporaneous market conditions that were known (or that should have been known) to Peoples -- actions that could have protected its ratepayers from exposure to price risk. In particular, Peoples took no action to fix or to cap the price of even the minimum quantity of gas its ratepayers could be expected to require in the coming heating season.

City Ex. 1.0 at 7, L. 155-60.

As shown earlier, the utility does not dispute the objective, quantitative evidence of market conditions pertinent to FY 2001. It only offers a different strained interpretation of that evidence. Peoples Gas' principal defense for its failure to hedge rests on Mr. Graves' arguments: that the Commission made hedging to protect consumers too risky for the utility by not providing enough guidance or encouragement; and that hedging is not required by the prudence mandate of PUA Section 9-220 without further Commission action. *See* PGL Ex. H at 606-85. The contemporaneous actions of the Commission, of other utilities, and of Peoples Gas itself all demonstrate the error of Mr. Graves' testimony. In fact, Peoples Gas' FY2001 inaction was a departure from its own recognition in prior years that prudent management does incorporate price hedging.

6. Staff's Conclusion That Peoples Gas' Hedging for FY 2001 Was Not Imprudent Is Not Well-Founded

The second of the two price risk management plans in effect during FY 2001 was the Gas Supply Price Protection Strategy adopted in April 2001. This plan did not become effective until April 2001, after the winter heating season of the reconciliation period. PGL Ex. P at 6, L.109;

Wear Cross Ex. 8. The winter months comprised the period of maximum price risk exposure for Peoples Gas' captive customers. City Ex. 1.0 at 8, L. 444-49. Managing price risk in those months has the greatest effect on customer bills. Apr. 21, 2005 Tr. at 1311. The result of Peoples Gas' imprudent delay was that the utility's ratepayers received no protection when they needed it most, and when prudence most required that Peoples Gas hedge the risks its customers faced. Both Mr. Herbert and Mr. Ross, after examining Peoples Gas' capabilities and hedging opportunities, concluded that the utility could have fixed or limited gas costs for the FY 2001 winter. *See, e.g.*, City Ex. 1.0 at 34, L. 845; CUB Ex. 1.0 at 15, L. 19.

Staff concluded that Peoples Gas' hedging efforts for the entire FY 2001 were not imprudent. Staff Ex. 12.00 at 74, L. 1564-65; Apr. 21, 2005 Tr. at 1312. That conclusion has no basis in the evidence of record. Experts for the City and CUB concluded that the utility's hedging for FY 2001 was wholly lacking or imprudently inadequate. Even Staff agrees that the Peoples Gas hedging plan in place during the crucial winter months of 2000-2001 was not adequate and did not meet the standard of prudent management. Apr. 21, 2005 Tr. at 1313. Thus, Staff's conclusion respecting FY 2001 depends entirely on the utility's hedging in the April-September portion of the reconciliation period.

The evidence shows (and Staff agrees) that customers' price risk exposure is greatest in the winter heating season, when prices and consumption are generally higher. *Id.* at 1310. Initiating a hedging program after the heating season could not (even in theory) outweigh the actual exposure of the high demand portion of the reconciliation period. That was the compelling reality. If Peoples Gas had hedged for the reconciliation period, as a practical matter, it would have occurred in the preceding summer. *Id.* at 1166. The hedging plan Peoples Gas

finally adopted and implemented in FY 2001 was in place only in the summer after the winter heating season of FY 2001. PGL Ex. B at 7, L. 140-42. Staff admits that Peoples Gas' hedging for October-March (the FY 2001 period of maximum price risk exposure for customers) was not prudent. Though Dr. Rearden attempts to minimize the effectiveness of hedging, circumstances can make its short term effect dramatic. Apr. 21, 2005 Tr. at 1310-11, 1316; City Ex. 1.0 at 18-19, L. 430-45. Hedging for an equal period, under different circumstances, is unlikely to offset the effect of use when it is most needed. Given the unpredictablility of price levels (Apr. 21, 2005 Tr. at 1310), and associated variability in the effect of a hedging program, hedging for only a portion of the year cannot be deemed prudent. The results of Peoples Gas' failure to hedge for FY 2001 -- bill spikes in the unprotected winter period followed by a relatively quiet summer under a new program -- confirmed the imprudence of incomplete hedging programs. City Ex. 1.0 at 18, L. 444-49.

Staff admits that Peoples Gas' hedging for October-March of FY 2001 was not prudent, and the record shows that the utility performed no hedging that benefitted the remainder of FY 2001. Staff's conclusion that the utility's hedging overall in FY 2001 was adequate is contrary to the evidence and logically unsustainable. In essence, Staff asserts that inadequate hedging for part of the year, when combined with no hedging for the remainder of the year, produced a prudent price protection plan for the entire year. That position should be summarily rejected.

7. The Harm to Ratepayers

On the separate task of estimating the economic harm to ratepayers, following a finding of imprudence, the experts for the City and CUB each presented an estimate. Mr. Ross presented

estimates based on hedging (a) only winter heating month supplies purchased under firm contracts and (b) 20% of all winter heating month supplies. CUB Ex. 1.0 at 16-17. Mr. Ross provided comparative estimates to give the Commission a sense of how different levels of hedging affected consumers. CUB Ex. 1.0 at 16-17. Observing that all supplies are subject to price risk (not just firm supplies), he does not recommend the first estimate. Mr. Ross describes his other estimate of $53,166,127 as the minimum disallowance the Commission should make. CUB Ex. 1.0 at 3, 21. That estimate, however, was subject to his acknowledgments that "the total appropriate disallowance in this reconciliation hearing is also dependent on the testimony of other witnesses and the [prudence] findings of the Commission," and that his estimate "does not necessarily address additional hedging opportunities related to weather-driven demand or alternative hedging strategies." CUB Ex. 1.0 at 17, 18.

Mr. Herbert independently developed his estimate of the harm to ratepayers from Peoples Gas' imprudent failure to hedge. Mr. Herbert began with a very conservative[16] calculation of the weather-based minimum volume of gas Peoples Gas would have to buy to meet its customers' FY 2001 winter heating needs. City Ex. 1.0 at 50, L. 1265-78. According to Mr. Herbert, that volume the utility must purchase regardless of weather or market changes is the amount to that should be hedged. *Id.* Using a conservative, objective hedging strategy and applying it to actual consumption volumes and contemporaneous price data for the FY 2001 winter heating months, Mr. Herbert estimated the harm to ratepayers at $229,984,352.[17] *Id.* at 55, L. 1387-90.

[16] In fact, his base of warmest recorded weather heating degree-days (lowest expected consumption) for each month was so conservative that Peoples Gas called it "extremely improbable."

[17] That amount was computed as the sum of the products for each month of the actual volume bought times and the difference between the unhedged prices Peoples Gas paid and the price it would have paid under the conservative, objective hedging protocol Mr. Herbert described .

Peoples Gas has presented no competing estimate of the harm to ratepayers (and the PGA disallowance) associated with the utility's imprudence in (a) failing to have in place an effective hedging programs for the reconciliation period and (b) choosing to hedge 0% of its assured minimum purchases for the FY 2001 winter.

I. Staff's Non-Monetary Recommendations Should be Adopted

The parties to this Joint Brief fully support Staff's non-monetary recommendations in this docket. PGL opposes four of Staff's nine non-monetary recommendations. Staff Ex. 5.00 at 20-22, L. 454-523. Because all of those recommendations are well-founded, the Commission should adopt them in their entirety.

The first of Staff's contested recommendations is that the Commission order that Peoples Gas immediately update its Operating Agreement, which was approved by the Commission on September 10, 1969, in Docket No. 55071. As Staff witness Steven Knepler testified, the conditions under which Peoples Gas operates have "changed dramatically" since 1969: no hub existed in 1969; PGL's relationship with EMW/enovate did not exist; and FERC regulations have changed since then. In addition, PGL's Operating Agreement approved in Docket No. 55071 does not specify how revenues are assigned or the basis for allocating joint costs, two basic conditions that are routinely included in recent operating statements earning Commission approval. *Id.* at 17, L. 384-91.

Second, the Commission should direct Peoples Gas to perform an annual internal audit of gas purchasing and submit a copy of the audit report to the Manager of the Commission's Accounting Department by May 1 of the year following the audit. This audit requirement would

remain in place until the Commission finds, upon a formal request by Peoples Gas, that an internal audit is no longer necessary. *Id.* at 221, L. 493-98. The basis for this recommendation is Peoples Gas' failure to maintain adequate records and internal management controls. Dr. Rearden identified Transactions 16 and 22 as representative of "the Company's lax oversight of trading practices" because PGL did not timely record those transactions and had to consult with EMW about the nature of the transaction when it called on the service for the first time. Staff Ex. 3.00 at 39, L 1030-38; at 41, L. 1074-76. Until it did so, Peoples Gas did not realize that the transaction was an exchange – as EMW claimed it was – and it therefore "needed to supply gas on its end." *Id.* at 41, L. 1067-71.

Third, Staff recommends that the Commission require Peoples Gas to retain outside consultants to perform a management audit of the utility's gas purchasing practices, gas storage operations and storage activities. The firm selected to perform the management audit would be independent of the utility, Staff, and GCI to Docket Nos. 01-0706 and 01-0707, and approved by the Commission. The audit would be managed by the independent directors of PEC's audit committee.

PGL would be required to submit monthly reports on the progress of the conduct of the management audit to the Bureau Chief of the Commission's Public Utilities Bureau, with a copy to the Manager of the Commission's Accounting Department, until the management audit report has been submitted. Upon completion of the management audit, which should be required no more than twelve months after the date a final order is entered in this proceeding, copies of the management audit report would be submitted to the Public Utilities Bureau Chief and the Manager of the Accounting Department. Staff Ex. 5.00 at 22, L. 506-20. As with Staff's internal

audit recommendation, the independent audit recommendation is designed to remedy Peoples Gas' "lack of internal controls" so that ratepayers are protected when the utility performs non-tariff transactions. Staff Ex. 2.00 at 61, L. 1282-84; *see also* Staff Ex. 3.00 at 61-62, L. 1614-39. Mr. Knepler explained that the need for a management audit is based, not only on Transactions 16 and 22, but on PEC's surrender to enovate of control over gas supply and storage functions; the diversion of revenues derived from PGA assets and expenses to enovate through EMW; the disclosure of oral agreements, including the RFG contract, profit-sharing agreements between PEC and Enron and arbitrary credits to offset PGA costs; and third parties' withdrawal of additional volumes of gas in PGL storage after those parties had depleted their bank of storage gas. Staff Ex. 5.00 at 13, L. 292-303.

Finally, Staff recommends that the Commission reopen Docket No. 00-0720, Peoples Gas' 2000 PGA reconciliation. *Id.* at L. 522-23. Doing so, on the basis of the new information available to the Commission (and possibly Peoples Gas' concealment of its activities), would allow the Commission to address matters uncovered in this proceeding that are equally relevant and material to the 2000 reconciliation proceeding – the imprudence of the GPAA, the relationship between Peoples Gas and its affiliates and Enron and its affiliates, PGL's lack of internal controls and the utility's imprudent use of gas in Manlove and leased storage. Staff Ex. 10.00 at 6, L. 109-18.

The contested non-monetary recommendations (as well as Staff's unopposed recommendations) are supported by substantial evidence, and should be adopted by the Commission in this proceeding.

V. CONCLUSION

For the reasons explained in the preceding discussions, the City of Chicago, the Citizens Utility Board, and the People of the State of Illinois ask that the Commission adopt the findings of fact and conclusions of law they propose in, and which are supported by, this brief. In particular the Commission should find that:

(1) That the Gas Purchase and Agency Agreement between Peoples Gas and Enron North America was imprudent. As a result, the Commission should adopt City-CUB witness Decker's recommendation that Peoples Gas be required to refund $37,470,517. City-CUB Ex. 1.0 at 7, L. 207.

(2) That Peoples Gas' third party storage and exchange activities associated with its operation of its Manlove storage field was imprudent. As a result, the Commission should adopt CUB witness Mierzwa's recommendation that Peoples Gas be required to refund $51,206,708. CUB Ex. 2.0 at 3.

(3) That Peoples Gas imprudently diverted assets and revenues to enovate during the reconciliation period. As a result, the Commission should adopt City-CUB witness Decker's recommendation that Peoples Gas be required to refund $20,652,322. City-CUB Ex. 1.0 at 66, L. 1887-89.

(4) That Peoples Gas' storage optimization contract with Enron Midwest was imprudent. As a result, the Commission should adopt Staff witness Hathhorn's recommendation that Peoples Gas be required to refund $1,340,455. Staff Ex. 9.00 at Schedules 9.02, 9.03.

(5) That Peoples Gas' refinery fuel gas arrangement with Peoples Energy Resources Corporation and Enron Midwest was imprudent. As a result, the Commission should adopt Staff

witness Hathhorn's recommendation that Peoples Gas be required to refund $2,232,490. Staff Ex. 9.00 at 13, L. 326-28, Schedule 9.01.

(6) That Peoples Gas' Trunkline deal arrangement with Peoples Energy Resources Corporation and Enron Midwest was imprudent. As a result, the Commission should adopt Staff witnesses Rearden and Hathhorn's recommendation that Peoples Gas be required to refund $372,088. Staff Ex. 9.00 at Schedule 9.04.

(7) That Peoples Gas' management of its gas lost and unaccounted for was imprudent. As a result, the Commission should adopt City-CUB witness Decker's recommendation that Peoples Gas be required to refund $38,102,680. City-CUB Ex. 2.0 at 34, L. 810-24.

(8) That Peoples Gas' price risk management (hedging) practices were imprudent. As a result, the Commission should adopt either City witness Herbert's more comprehensive recommendation that Peoples Gas be required to refund $229,984,352 (City Ex. 1.0 at 55, L. 1387-90); CUB witness Ross' recommendation that the utility be required to refund $53,166,127 was viewed by Mr. Ross as the minimum estimate of harm. CUB Ex. 1.0 at 3, 21.

(9) Finally, the Commission should adopt Staff's non-monetary recommendations. Those recommendations are described in the testimony of Staff witness Steve Knepler. Staff Ex. 5.00 at 20-22, L. 454-523.

Because of the distinctive analyses of various experts in the case, there may be some overlap in their estimations of ratepayer harm. Although the figures shown above are not additive, they are reasonable estimates, and should be accepted by the Commission.

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Respectfully submitted,

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